The Impact of Rent Review on Rental Housing in Ontario : A Staff Research Report

This publication was prepared by the staff of the Ministry of Municipal Affairs and Housing with the assistance of consultants. As a staff research report, it represents the technical analysis of staff alone and does not indicate policy direction.

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This report is based on computer simulations, surveys and statistical analysis, in addition to extensive searches of the existing literature. As such, it represents an extremely complicated research project that attempts to integrate many contributions into a coherent whole. Because of this, the final product inevitably contains interpretations that will not represent the views of all involved in the report. Nevertheless, it is also true that everyone made significant contributions to the overall effort and it would have been impossible to prepare this document without their assistance.

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CHAPTER 1 - Summary of Findings

Introduction

In the six years since the establishment of rent review in Ontario, there has been a good deal of public interest in the implications of the legislation on tenants, landlords, and others. This report examines evidence related to some of the important issues.

The questions addressed are:

- What impact has rent review had on rents and on the supply and demand for rental housing?
- To what extent are maintenance levels of rental buildings regarded as inadequate or deteriorating?
- How have rates of return fared under rent review, and what impact has this had on landlords' behaviour?
- Have there been other direct and indirect effects of rent review that have had important consequences?
- How well does rent review perform as a means of assisting tenants with housing affordability problems?
- To what extent are the redistributive effects of rent review shared equitably among landlords and tenants?
- How does rent review relate to tenant security of tenure and to the property rights of landlords?
- How do rent review policies relate to basic economic values and perceptions?

In examining these issues one is continually confronted with the necessity of making choices between problems. Each of the problems raised can be solved individually, but only at the cost of accepting some other problem. This fact is by no means unique to the issue of rent review. It is true of most social and economic policy issues. In the final analysis, one must choose the problems one wishes to have.

A Brief History

In December of 1975, the Legislature of Ontario passed The Residential Premises Rent Review Act. This Act limited rent increases on buildings rented prior to 1976 to 8 per cent unless the landlord received approval from a Rent Review Officer for a different increase. Decisions of the Rent Review Officer were to be based, in large part, on increases in costs, although provisions were also made for elimination of financial loss and for rent reductions in cases where services had been eliminated.

The original legislation was scheduled to terminate in August of 1977. In that year, however, the legislation was extended. The rate of allowable rent increase was reduced to 6 per cent in the fall of that year.

In 1979, The Residential Premises Rent Review Act was replaced by sections proclaimed from The Residential Tenancies Act. The new Act retained the 6 per cent increase and the cost based criteria for landlord applications. For the first time, a relief of hardship provision was included that permitted the Residential Tenancy Commission to make an award of additional revenue to the landlord equal to a maximum of 2 per cent above costs. The new legislation also changed the basis for tenant applications from a cost based system to one based on the rental levels in comparative units. Finally, the new Act did not contain a termination clause.

Supply and Demand (Chapter 2)

In recent years, rental vacancy rates have fallen in many parts of the Province. By October of 1981, 9 of the 10 largest urban areas in Ontario had vacancy rates below 3 per cent. The Toronto vacancy rate was 0.3 per cent. In the Toronto Census Metropolitan Area, rents on uncontrolled units began to climb in 1981.

As vacancy rates decline a major issue will be the relationship between rents in controlled and uncontrolled buildings, in that, the lower the rate of rent increase in the controlled sector, the larger the rent increases in the uncontrolled market will be.

It is important to understand why this inverse relationship will develop between controlled and uncontrolled rents. Until quite recently, vacancy rates throughout the Province have been high enough to ensure that enough competition existed so that uncontrolled rents stayed roughly in line with controlled rent increases. In some areas, most notably Toronto, vacancy rates have now fallen to levels where competition no longer serves as a fully effective limit on uncontrolled rent increases.

With controlled rents limited to below the rates of price and wage increases, controlled units have become underpriced with a resulting stimulation of demand. In large part this additional demand has been by non-family household units: young people leaving home or those obtaining separate units instead of sharing accommodation with friends. In contrast to the increased demand, the supply of controlled units in some areas may be decreasing, either because of the natural aging process of the units or because of the increasing value of the units for other uses, including homeownership.

The combination of increased demand and diminished supply of controlled units produces a spillover of demand into the uncontrolled sector and this increased demand results in the upward pressure on the rents of these uncontrolled units.

The implications of this analysis have been explored for both Toronto (a low vacancy rate area) and London (a higher vacancy rate area). Scenarios have been developed using a number of assumptions about background economic conditions and other rental policies.[1] These assumptions have been held constant, however, in order to isolate the impact of rent review on future developments.

Table 1.1 presents the outlook in the Toronto area for both controlled and uncontrolled rents. The most noticeable feature is the strong run up of uncontrolled rents in the 1982 to 1984 period. In part, this is due to the starting point of low vacancy rates combined with subsequent increases in demand associated with demographic and economic forces and the inadequate volume of new supply. It is also apparent, however, that the extent of uncontrolled rent increases is strongly related to the rate of controlled increases. Higher guideline rates produce lower increases in the uncontrolled sector.

Table 1.1

Average Annual Increase in Real Rent
(Rent Increase in Relation to Inflation)
Alternative Scenarios for Toronto

Guideline Policy From 1982 on	Controlled Rent		Uncontrolled Rent	
	1982-84	1984-86	1982-84	1984-86
	(Per Cent Change)			
4% Guideline	-8.3	-6.5	+23.8	-0.7
6% Guideline	-5.1	-3.2	+20.6	-2.2
9% Guideline	-0.6	+0.8	+16.3	-3.1
Inflation Rate Guideline	+1.5	+0.3	+14.7	-3.4
Decontrol	+14.4	+2.3	+5.1	-4.3

Source: Computer simulation performed by Econalysis Consulting Services.

[1]Major economic assumptions: deceleration of inflation to about 8 per cent in 1985-1986; reduction in interest rates by stages to 12 per cent in 1986; moderate growth in incomes relative to inflation; and a continued gradual decline in demographically based demand. Major policy assumptions: continuation of Ontario Rental Construction Loan and a tax write-off similar to the Multiple Unit Residential Building tax write-offs or the introduction of new assistance of equivalent value.

The 1984 to 1986 period shows a much different pattern. In part this is due to the fact that increasing rents in the uncontrolled sector attract additional supply either through the building of new units or the transfer of units from ownership to uncontrolled rental use. The belief that these units will not subsequently be controlled is crucial to this supply effect. Another effect of the rise in the real rent level for the uncontrolled sector in the period 1982 to 1984 is a reduction in rental demand. A major consequence of these two market trends of increased supply and reduced demand is a higher vacancy rate in the uncontrolled sector by 1986. The other factor at work relates to the increase in controlled rents. The higher the controlled rent increase, the lower the increase in uncontrolled rents relative to inflation. This is because increased controlled rents serve to reduce demand, thereby reducing demand spillover into the uncontrolled sector, and also reduce the rate of transfer of units from controlled to ownership use.

The situation in London differs greatly from Toronto because of the higher level of current vacancies. Table 1.2 presents the information for London on controlled and uncontrolled rent increases. Uncontrolled rents do show a tendency to increase more rapidly the lower the level of controlled rent increase, because of the declining vacancy rate that develops under these conditions.

Table 1.2

Annual Average Increase in Real Rent
Alternative Scenarios for London

Guideline Policy From 1982 on	Controlled Rent		Uncontrolled Rent	
	1982-84	1984-86	1982-84	1984-86
	(Per Cent Change)			
4% Guideline	-7.6	-5.8	+6.8	+2.0
6% Guideline	-4.7	-2.9	+4.8	+1.1
9% Guideline	-0.4	+0.7	+2.4	-0.1
Inflation Rate Guideline	+1.4	+0.2	+1.1	-0.2
Decontrol	+2.0	+0.3	+0.6	0.0

Source: Computer simulation performed by Econalysis Consulting Services.

At higher guideline rates the increases in both controlled and uncontrolled sectors are moderate in relation to inflation. Thus, while the same forces are clearly at work in London as in Toronto, the effects on London are much more moderate. Most other cities in Ontario would fall between these two in terms of market reactions.

Maintenance (Chapter 3)

One of the concerns shared jointly by tenants and landlords is the possibility of deterioration in maintenance levels under rent review. The economics of this potential development are straightforward. If landlords are not allowed to maintain their profits in line with increasing inflation by raising rents, then they can be expected to attempt to do so by reducing costs. And maintenance is an area of expenditure that is often regarded as particularly vulnerable to cutbacks in that other reductions are more difficult to make or more immediately visible.

In contrast to the already deteriorating conditions of supply and demand, there is little evidence to date of serious reductions in the observed quality of maintenance conditions. For a number of years the Ministry has conducted a rental market survey which asked tenants, among other things, to rate their perceptions of maintenance. Invariably, the finding was that over one-half of all respondents rated their maintenance as good or very good, while another quarter rated it as adequate. Only 10 to 20 per cent rated it as poor or very poor. Also, two-thirds or more of all tenants indicated that standards had not changed in the past year, with the remaining third split between improving and declining conditions.

The general results of these previous surveys have now been confirmed by a comprehensive set of surveys conducted for the Ministry in Toronto. The set of surveys included not only tenants, as in the previous surveys, but also landlords and independent site visitors. Furthermore, the range of questions probed much more deeply into the observations of maintenance conditions.

Regarding the current state of overall maintenance, some 80 per cent of site visitors and 90 per cent of all landlords indicated that levels of maintenance were good or very good.[2] When tenant views were averaged for each building, some 55 per cent of all buildings were given a rating of good or very good, and almost 40 per cent of all buildings had an average tenant rating of adequate.[3] In these three surveys the number indicating poor maintenance was under 20 per cent and the number of very poor buildings was less than 3 per cent.

The evidence on changes in maintenance is just as clear. In about 90 per cent of all buildings the average tenant response was that maintenance had remained the same over the past year. For the same period of time about two-thirds of all landlords reported no change in standards of janitorial care and repairs, while about one-fifth indicated improvements in the past year.

[2]No "adequate" category was included for either landlords or site visitors.

[3]Some of the difference in tenant view between this maintenance survey and the previous rental market surveys is due to the averaging of responses for buildings.

The survey also indicated that low levels of maintenance tended to be associated with older buildings, low rent buildings, buildings where tenants indicated 24 hour maintenance service was not available, and buildings owners intended to sell. High ratings tended to be associated with the opposite characteristics. Building size was not strongly related to higher than average or substantially below average ratings, although the smallest size surveyed (20-49 units) did tend to have ratings just below average. It should be pointed out that a number of individual buildings had maintenance performances that differed from these generalizations.

The landlord survey also asked the respondent to indicate the obstacles to better maintenance. Almost one-third indicated no obstacles, while over half mentioned either lack of funds or rent review. Age of building or equipment was mentioned by one in eight, while several other responses were indicated by a scattering of owners.[4]

In general, tenants, landlords and site visitors have confirmed that, in terms of results, maintenance levels in Ontario are good or very good and landlords and tenants agree that little change is occurring in these levels. To the extent that maintenance falls short of ideal, landlords attribute this to financial factors, including rent review.

Rate Of Return (Chapter 4)

In considering both the supply of rental units and the maintenance of buildings, profit performance appears to play a role in the process of providing an adequate quantity and quality of rental housing. Thus, it is of importance to tenants, as well as landlords, that adequate returns exist.

Landlords are concerned not only with the expected level of profits, but also with the amount of uncertainty associated with that return. The higher the return, and the lower the risk, the greater the incentive to provide rental housing.

In this study attention has been given to both the return on total capital, including both landlord and mortgage lender, and the return on equity of the landlord alone. While there are important differences in the interpretation of these measures, the overall results tell a consistent story in this case.

In order to examine the financial returns on rental investment, landlords were surveyed in both Toronto and London. One-third of the landlords approached provided access to financial information. While this response does not permit one to use the results as representative of all landlords, it does provide a detailed look at the financial and management performance of a number of landlords.

[4] A number of landlords mentioned two factors.

The adequacy of returns can be judged in a number of ways. First, actual returns can be compared to a landlord's own definition of adequate return. Second, returns can be compared to the rate of inflation. Third, return on rental buildings can be compared to that available on other investments. Finally, adequacy of return can often be reflected in the management behaviour of landlords. Each of these methods can be used in evaluating the performance of surveyed landlords.

As part of the survey, landlords were requested to indicate the rate of return that they considered adequate on their investment. This amount was compared with the return they actually achieved. For the 59 properties for which comparisons could be made, 34 of them (58 per cent) experienced a return lower than their target rate.

Both the annual return to total capital (including mortgage lender) and to the landlord alone were compared with the rate of inflation. The return to total capital exceeded the rate of inflation in six of the ten years (1971-1980) while the return on landlord equity increased by more than the rate of price increases in only one of the ten years.

Two comparisons with other investments were made. The return on total capital after tax averaged 6.3 per cent for the landlords responding, whereas the return for industry in general was 11.7 per cent. The return on equity before tax was 14.1 per cent for the sample, and 15.4 per cent for stocks on the Toronto Stock Exchange Index of 300 stocks. The return on landlord equity was substantially higher than the return on fixed income bonds during the 1970's, but this relationship is now quite different given current interest rates.

The management behaviour of landlords is particularly important in that it directly affects tenants. As part of the survey, landlords were asked questions that dealt with key management decisions. It became apparent in analyzing the results that many of the landlords saw themselves faced with a decision between adequate profits and quality operation of their building.

In all, seven distinct management strategies were identified. Five of them involved either below average profitability or reductions in quality or both. One group was being forced out of business by large cash flow losses. A second was systematically taking its investment equity out of its building. A third was cutting back on current expenditures in order to retain good levels of profits, while a fourth was maintaining cash flow by deferring capital expenditures. The fifth group was maintaining building quality and increasing equity, but was suffering from below average rates of return.

Of the two other groups, one was distinguished by the fact that it relied heavily on large current cash flows from Multiple Unit Residential Building (MURB) tax write-offs. The remaining group was able to have above average profits and to maintain high quality buildings.

The overall conclusion is that a considerable number of landlords are experiencing some degree of financial pressure and in a number of cases this is affecting the quality of building operation. While the

Maintenance Survey found that results had not yet been seriously affected, it would appear that a number of landlords are cutting back on expenditures. This implies that reductions so far have been limited to either efficiency improvements or to marginal reductions in service. Some question exists, however, as to whether future reductions will be as innocuous in that limits must exist on the potential for such savings. Beyond this point, cost reductions will have an impact on the level of services.

Direct and Indirect Costs (Chapter 5)

The major additional impacts concern the direct and indirect costs to government of rent review and the potential implications of rent review for decline in respect for the legal system.

While the direct cost of rent review was $5.5 million in 1980, the costs to all levels of government were in the order of $100 million in that year. Indirectly, rent review contributed to additional expenditures associated with the federal Assisted Rental Program, and the provincial Ontario Rental Construction Grant. In addition, rent review contributed to a number of reductions in tax yield to all levels of government. At the federal and provincial levels there were reductions associated with the MURB tax write-off, reductions in the income and capital gains taxes from landlords, and loss on the provincial capital tax. Municipal property taxes were also lower given the reduction in new rental construction. Thus, the cost to governments, and to taxpayers generally, go far beyond the direct program expenditure for rent review and affect all three levels of government.

Respect for the law is fundamental to social order. Laws that give rise to wide abuse, therefore, serve as a challenge to that order. Reports of evasion, key money, black markets and similar practices should be of general public concern. The extent of these practices could not be documented in the study.

Other costs that are difficult to quantify are: the increased search time for rental units by tenants in tight rental markets; the loss by tenants who have to settle for units that are sub-optimal in terms of characteristics or location; and the costs and frictions experienced by both landlords and tenants in the process of compliance with the legislation.

Affordability (Chapter 6)

The impact of rent review on the affordability position of tenants is an important issue in the consideration of the performance of the program. Of relevance to such an evaluation is the number of those helped and the efficiency of rent review in providing assistance.

The number of people with affordability problems depends on the definition of what constitutes a problem household. In 1978, the

percentage of unsubsidized renter households paying over 25 per cent of their income on rent was 30.2 per cent, while 23.2 per cent paid over 30 per cent of income on rent. The sensitivity of these estimates to changes in rents can be seen in Table 1.3. As can be seen, a 10 per cent change in rents relative to income changes the per cent of those with a problem by 3 to 4 percentage points. In that wages and other incomes have been increasing at more than average rent increases since 1978, the number with affordability problems is probably declining.

TABLE 1.3

Sensitivity of Affordability Measures to Changes in Rents Relative to Income 1978

Per cent Change in Rents Relative to Income	Per cent of Households with Problem	
	25% Threshold	30% Threshold
10% higher	35.9	27.1
5% higher	33.2	25.3
no change	30.2	23.3
5% lower	28.4	21.9
10% lower	26.4	20.4

Source: J. Miron "The Affordability of Rental Housing in Ontario: Empirical Findings," (Ministry of Municipal Affairs and Housing 1981) based on unpublished data from Statistics Canada Household Income, Facilities and Equipment, 1978.

While rent review has played a role in reducing the number of those who have affordability problems, there certainly may be some questions as to the efficiency of the program. It should be obvious that if 23 to 30 per cent of private market tenants had an affordability problem in 1978, then 70 per cent or more of tenants did not have a problem. Indeed, only about one dollar in four of rent reduction went to those with the worst affordability problem, i.e., those spending over 30 per cent of their income on rent. When other costs of rent review borne by government ($100 million) are combined with the costs to landlords of rent reductions ($160 million), about one dollar in seven ($39 million) was transferred to those with an affordability problem. Clearly, these transfer efficiency rates are well below those that would be attainable from alternative measures more specifically targeted at those with affordability problems.

Redistribution (Chapter 7)

The fairness of the rent review policy is partly dependent on the allocation of impacts of rent reduction and the corresponding loss of income.

One way of viewing these impacts is in terms of the allocation of benefits and costs among income groups. Rent review does accomplish some degree of redistribution from higher to lower income groups. About one-third to two-fifths of households with low and moderate incomes benefit from rent review, while a smaller percentage of higher income people derive benefits. Also, about three-quarters of the cost in terms of rent reduction are borne by the top 60 per cent of the income distribution.

While the net distribution goes from rich to poor, rent review is far from perfect as a method of redistributing income. Over one-half of the total benefits go to the top 60 per cent of households by income. Renters in the highest income groups receive average rent savings that are 40 per cent more than those in the lowest income group. The cost in reducing income is borne by only a small proportion of the population implying substantial costs to landlords, while others of the same income level bear no direct costs. And, as indicated above in the section on Supply and Demand, there is a growing inequity between tenants and landlords in the controlled and uncontrolled markets.

Redistribution can also be looked at by age and family type. A clear finding is that rent review redistributes income from those over 40 to those who are younger, with the largest net losses being borne by those 65 and over and the largest net gains going to those under 25. While rent review undoubtedly benefits many older tenants, their gains are less than the financial loss experienced by the elderly with rental investments.

In so far as household type is concerned, it is interesting to note that the estimated rental savings of tenants with children is less than the savings of non-elderly childless individuals and couples. Clearly, the program is not one targeted at families with children.

Security of Tenure (Chapter 8)

The right to continued occupancy of a rental unit is of great importance to tenants. Not only can moving be costly and disruptive, but individuals often attach a considerable value to retaining their own home, whether that home be rental or ownership. Rent review is often seen as essential to the preservation of security of tenure in that a high rent increase can drive a tenant out as surely as a notice of eviction. Indeed, the term "economic eviction" can be applied to such cases.

The provision of security of tenure is quite recent in Ontario. Prior to 1970, tenants had no security of tenure beyond that specified in their lease agreement. In 1970, the first reforms were implemented which required landlords to obtain a writ of possession from the county or district court in order to evict. The court could refuse an eviction

where the landlord was in breach of his obligations or in cases where tenants were attempting to enforce their legal rights. In 1975, coincident with the introduction of rent review, a major additional step was taken towards full security of tenure, whereby landlords could only obtain an eviction for causes specified by legislation.

Every increase in security of tenure, or in other restrictions, constitutes a reduction in the effective property rights of landlords. The Landlord and Tenant Act restricts eviction and termination. The Residential Tenancies Act restricts rents and reductions in maintenance. The Planning Act and municipal policy restrict conversion of rental units to condominium use. Pressure also exists for extension of restrictions to exclude adult only buildings and to limit demolition of rental buildings. Taken together, such restrictions would limit all the major decisions that landlords could formerly make on the use of their property. Accordingly, such restrictions limit the attractiveness of rental development.

To a considerable extent, landlords have come to accept the restrictions related to security of tenure. They have a great concern, however, with the delays involved in current procedures. The Residential Tenancies Act would have expedited these procedures by taking the process out of the court system and placing it with the Residential Tenancy Commission. This change would also have applied to items of significant importance to tenants. The Supreme Court of Canada, however, ruled these Sections of the Act beyond provincial jurisdiction.

Related to security of tenure is the concept of security of choice. Low vacancy rate conditions may limit the degree to which tenants may move in response to either changing need or to avoid deteriorating conditions. To the extent that low vacancy rates are associated with rent review and the administration of security of tenure, these will be in conflict with the desire for security of choice.

Finally, there is the issue of how security of tenure could be guaranteed in absence of rent review. To deal with the problems faced by these tenants, consideration could be given to restricting unconscionable increases beyond market levels. This would serve to eliminate economic evictions.

Values and Perceptions (Chapter 9)

The empirical analysis in the report does not cover the full range of issues related to rent review. In addition, there is also a strong social value component to the debate. As well, the concerns addressed by rent review must be seen in the context of the attitudes formed in the current inflationary environment.

There are three sets of social values that can be distinguished in the discussion of rent review. They may be termed the "free market," the "cost only," and the "adjustment and protection" approaches.

The free market approach is characterized by its emphasis on individual freedom in making decisions. Most economic transactions are, in this view, to the mutual benefit of both parties. The competition among thousands of landlords is seen as the mechanism whereby increased profits of landlords are translated into the additional supply required to meet demand conditions. The ability of prices to adjust to changed economic circumstances is judged appropriate not only for its own sake, as an expression of economic freedom, but also because of its contribution to total welfare, in meeting the needs of others.

At the core of the cost only approach is a view that profit levels should be reduced. The extreme view would eliminate profits altogether. In essence, this view holds that rental housing should be regarded as a public utility. In more moderate form, profits are to be frozen in dollar amount, with inflation allowed to eat away at the value over time. Thus, unlike wages, the incomes of landlords would not to be allowed to adjust with inflationary conditions.

A number of beliefs can be at the basis of the cost only view. One is that profits are never justified. A second is that competition does not exist. A third is that demand conditions should not be allowed to influence prices. A fourth view is that changes in rents to reflect changed economic circumstances are not warranted either because it is believed that circumstances have not fundamentally changed or because it is believed that renters should be protected indefinitely from such changes. Each of these views rejects the role of market prices in the economic adjustment process.

The adjustment and protection approach accepts that higher costs including interest rates and greater demands for rental units indicate a need for adjustment in the price of rental units. This view, however, notes that housing markets can adjust only slowly to changed conditions given that new production is low relative to the entire stock. Thus, while accepting the need for current controls, it also accepts the need for longer term adjustment to free market values. Hence, controls are to be structured with the objective of phasing in the longer term market balance.

Recent inflationary conditions have served to disorient many people in making economic judgments. A wage earner may be concerned about a 6 per cent rent increase despite the fact that his wage may have risen by 12 per cent. Others look to the guideline as a means of increasing certainty or as a means of making up for a failure of income to increase. Finally, one may look to rent review as a component in an anti-inflationary policy.

On the other side, one should look at a landlord view. Controls at 6 per cent are lowering the rent to income ratio of his wage earning tenants, while his profit levels are frozen or declining in real terms. Any increase in certainty of rent increases for the tenant, means that landlord's profits bear the risks of higher inflation. Also, while rent saving lowers inflation for tenants, it does not for landlords.

CHAPTER 2 — Supply and Demand

Central to any discussion of rent review is the impact it has on the supply and demand for rental housing. An analysis of supply and demand focuses on a variety of issues:

- the extent to which rent review lowers the price of rental accommodation;
- the extent to which rent review discourages the production and retention of rental supply;
- the extent to which lower rents stimulate increased demand for units;
- the extent to which various aspects of rent review (e.g., level of guideline for rents) affect rental markets.

These are important questions in themselves. In addition, they are relevant in making an evaluation of other aspects of rent review. For example, the impact on rent increases will affect both the landlord's rate of return and the tenant's ability to afford rental housing.

In this Chapter an economic simulation model will be outlined which will describe the functioning of Ontario's housing markets. This model has been applied in both Toronto and London, Ontario, two cities with largely different rental markets in terms of composition and degree of market pressure as measured by vacancy rate statistics.[1] The results from these simulations will be used to address the issues outlined at the start of this Chapter.

The following sections will deal with: a description of the workings of the Ontario housing market, the results from the Toronto simulation and the results from the London simulation.

The Housing Market in Ontario

In studying the Ontario housing market it is necessary to deal with three components. First, there are many regional housing markets in Ontario rather than one integrated market. Second, each housing market has a variety of housing choices. For purposes of this study the most important distinction is by tenure: controlled rental, uncontrolled rental and ownership housing sectors. Third, each of the housing sectors involves both suppliers of housing (developers and landlords) and

[1] In October, 1981, the vacancy rate calculated by Canada Mortgage and Housing Corporation, including recently completed units, was 0.3% in Toronto and 1.9% in London.

demanders of housing (tenants and homeowners). The interaction of suppliers and demanders of housing will result in the determination of market prices which may be further affected by the existence of rent review and other factors.

As already indicated, simulation models were prepared for both Toronto and London in view of the marked differences between these markets. In both cases the models were based on the Census Metropolitan Area (C.M.A.) definition of the urban market. This definition is based on the strength of the live-work linkages in the area and as such serves as a natural definition of a housing market. It is true that some people will commute across C.M.A. boundaries in going to work (e.g., someone in Oshawa may work in Scarborough) but the C.M.A. boundary is as close as one can come to defining a housing market. It is also true that within a housing market there may be important differences (e.g., between downtown Toronto and Mississauga) but data availability limits the degree to which such differences can be taken into account.

Given the existence of three housing sectors (controlled rental, uncontrolled rental and ownership) and three components to analyze within each sector (supply, demand and price determination) there are a total of 3x3=9 interacting model segments that describe the operation of the housing market in Toronto or London. This description will proceed with a general discussion of the three components (supply, demand and price determination) and will be followed by a specific analysis of each of these components within the three housing sectors (controlled, uncontrolled and ownership).

It might be noted at the outset that the model[2] employed in the analysis uses data that has been adjusted for inflation. The reason for this is that a 10 per cent increase in income, for example, can be expected to have a different effect on housing demand if prices are stable than in a situation where prices are increasing by 15 per cent. In the first case, the individual would be becoming better off and could afford more housing, while in the second case, the individual would be falling behind inflation and might be forced to do with a lower standard of housing. A similar argument applies to other economic variables.

While most of the model components are specified in real terms (i.e., after adjustment for inflation) there are four ways in which changes in inflation have an impact on the model.

First, there is a bias toward ownership housing under inflationary conditions. Ownership housing is free from capital gain taxation on any increase in value. Other forms of investment, however, are subject to this tax even if the increase in value only matches the inflation rate. For this reason there is an advantage in putting one's savings into purchase of a house that one will live in, rather than into other investments. This bias will be greater, the higher the inflation rate. As will be seen, the model will incorporate this effect of inflation.

[2]The actual model is set out in the report by Econalysis Consulting Services to the Ministry of Municipal Affairs and Housing (1981).

Second, changes in inflation will cause corresponding changes in the rate of real rent increase in the controlled sector. Thus, at 9 per cent inflation a 6 per cent guideline causes a 3 per cent drop in rents relative to inflation, whereas at 12 per cent inflation, rents in the controlled sector will drop in real terms by 6 per cent with the same guideline.

Third, the supply of new units to the uncontrolled rental sector will be affected by the potential risk of future extension of controls to these units. The cost of any such extension will be greater, the lower the guideline increase is relative to the rate of inflation.

Fourth, empirical testing indicated that the process of rent change should be estimated in nominal terms rather than real terms. That is, the process of adjustment in rents is specified in terms of changes in rent without adjustment for inflation. This means that tenants and landlords have a tendency to think in terms of nominal rents in the process of determining rent increases.

(a) general remarks on model components

Supply, demand and price in the model are simulated for the private rental market. The public housing rental market is excluded for two reasons. First, rent review directly affects only the private market and the decisions to increase the supply or to be a part of the demand for public rental housing have determinants that are significantly different than for the private market. Second, while there is some interaction between public and private markets, the degree of interaction is judged both low enough and complicated enough to argue for exclusion of the public market. The interaction is low because the suppliers are distinct and the target tenant populations substantially different. The interaction is complicated because of the non-economic components of public market decisions.

The supply side of private housing markets are responsive to changes in profitability and constrained by public decisions. Because housing cannot be produced instantaneously, at any given time, the stock of housing can be taken as fixed. This stock, however, will vary over time by completions of new units, demolitions of old units and transfers of units between housing sectors. The rate of completions is, of course, the result of previous housing starts which have been determined by the level of profits expected. Demolitions and transfer of units between sectors are motivated by profitability but are also subject to public decisions to permit demolitions or transfers between rental and ownership use. The rate of transfer of stock between sectors will be assumed to vary with the relative prices or rents of housing. Demolitions, however, will be taken as a fixed per cent of stock. Finally, it is assumed that the new supply of housing to ownership and rental markets can be treated independently. That is, if both rental and ownership housing are profitable to build, the private sector will build both. This will be true if sufficient capacity exists for expansion of both

forms of housing (certainly true at present) so that financing, labour, materials and land can be obtained if market conditions warranted expansion.

The demand for housing in the three sectors are strongly inter-related. The decision to form a household and the decision between controlled rental, uncontrolled rental and ownership housing will be dependent on the costs of these various alternatives, the income of the household and the age and other characteristics of the household. Thus, both the total demand for housing and the decision between housing sectors will depend on:

- rent levels, controlled and uncontrolled;
- ownership prices;
- household income;
- inflation rate;
- mortgage rate;
- number of households by age, sex, family status;[3]
- local labour force.[4]

Total housing demand will increase as rents and ownership prices go down as incomes rise and as the numbers of households and local labour force increase. Both the inflation rate and the mortgage rate were found not to have any significant impact on total housing demand, but do affect the tenure split.

Because of the existence of controls the relationships being modelled are more complicated than those in markets that are not subject to goverment controls. Controls, in keeping rents down, will cause three shifts in demand. First, some increase in the number of households formed can be expected given the low cost of controlled housing. In that few families do not have separate housing units, most of the new households formed in response to low rents will be non-family, especially young people deciding to live on their own. Second, renters can be expected to favour lower cost controlled units over new higher cost uncontrolled units. The degree of this attraction increases with the size of the rent differential but is limited both by the degree of difficulty in finding a low-rent, controlled unit and by various quality and locational

[3]This variable includes the effect of the variable determining the split in the number of households by tenure.

[4]The local labour force variable was introduced in order to capture several effects: short-term local migration, inter-relation between secondary earners and homeownership and the impact on separate household status of young people entering the labour force.

differences between units. Third, low rents in the controlled sector will reduce the demand for ownership housing. This effect may be particularly large at the low cost end of the ownership market, including condominiums. Given these three effects of controls, the demand for housing relationships have had to be altered to include these influences.

Price formation in the three sections to be outlined will depend on market pressures measured by vacancy rates, except of course, where these market forces are limited by controls. Thus, rent increases where not controlled are the result of the balance between supply and demand. Furthermore, prices clearly enter the supply process as one element of determining profitability and the demand process as a major element in determining total demand and the choice between housing sectors.

(b) the controlled rental market

The general comments of the previous section can now be expanded in the context of the controlled rental market.

The supply of controlled housing differs from the general outline in that under current legislation new units are exempt for all-time from controls. Thus, the controlled stock cannot be increased through housing starts. This means that controlled supply will decrease over time at a rate determined by demolitions and transfers to other housing sectors. As noted in the general comments, transfers are assumed to respond to changes in relative prices and rents[5] while demolitions are modelled as a fixed per cent of stock.

The demand for controlled housing is determined in two stages. First, the demand is estimated based on historical relationships between rental housing demand and the seven factors specified in the general discussion, given the controlled level of rent.

Thus, the demand for controlled housing will increase as: the controlled rent decreases (cheaper to rent), ownership prices increase (alternative less attractive), incomes increase (as more people can afford housing units[6]), inflation decreases (fewer switch to ownership to gain tax advantages), mortgages rates increase (again reducing ownership demand), as households adjusted by age, sex and family status increase and as the local labour force expands.

This will yield the demand for units at the controlled price. This demand, however, must be adjusted to allow for allocation of demand

[5]That is, if controlled rents fall relative to ownership prices, there will be an incentive to convert units from rental to ownership use.

[6]This effect is thought to out-weigh the decrease in rental demand associated with income increases which shift renters to ownership status.

between the controlled and uncontrolled sectors. In general, the demand for controlled rental units will increase with the amount of rent differential between controlled and uncontrolled stock, but be limited by differences in quality and location advantages of new units and by the degree of difficulty in acquiring a controlled unit of appropriate characteristics. The difficulty in obtaining a unit will be dependent on availability as measured by the difference between the supply of units and the adjusted demand. The end result is the determination of the actual consumption of controlled rental units. The number of vacant units will be equal to the supply of controlled units minus actual consumption of them.

Prices in the controlled sector, as long as controls are in place, will be assumed equal to the guideline rate of increase if controls are binding. This is generally in line with the findings of the Ministry of Municipal Affairs and Housing annual Rental Market Survey. It is true that some units go to rent review and obtain higher increases, but it is also true that surprising numbers of landlords charge low, or even no increase to their tenants.

It is possible, however, that controls will not be binding in a given market. If the rent increase allowed by controls is higher than that which can be supported in the market, then market rents will prevail.

If rent review were removed, rents would then increase toward market rates. In some cases, the annual adjustment would simply be that determined by the relationship between rent increases and vacancy rates. In other cases, however, the increase of controlled rents would be higher given the need to adjust controlled rents to levels consistent with market rents, after due allowance for quality differences in units. The rate of any adjustment to market rents would be limited by the existence of leases, goodwill and any delays in recognizing changed circumstances.

(c) the uncontrolled rental market

The supply of uncontrolled units in the private sector was zero at the start of 1976. Since then the supply of this sector has been increased by new rental completions and by transfers from the controlled sector by means of the $750 exemption since 1979 and transfers from owned to rental use.[7]

Rental completions are the result of previous housing starts. Starts depend on profitability which is determined by rent levels on uncontrolled stock, the rate at which rents are increasing, the cost of operating rental units, the cost of construction and the cost of mortgage loans. In addition to these considerations there is the risk of control perceived by the landlord. The potential revenues from new rental units

[7]Given the newness of uncontrolled stock, demolitions are assumed to be zero.

is subject to the risk of future extension of controls. Accordingly, landlords will be sensitive both to the degree of risk and to the loss that would occur on future control. The latter is dependent on the difference between the rate of inflation and the control guideline. Finally, the profitability of building may be enhanced by the value of government assistance programs which may be seen as a reduction in the cost of building.

The link between economic conditions, rental starts and rental completions is a two stage one. First, the model implies that developers build on the basis of reasonably sound projections of costs and revenues for their units. In particular, a six month forecasting ability is assumed. Having started a rental project, the time to completion will vary according to the type of unit. Here the time between start and completion is taken as an average of one year, with the first completions occurring six months after the start. The combination of the forecast of economic conditions and the delay between start and completion yields a total delay in the model, between economic changes and completion, of an average of six months.

The demand for uncontrolled units is again estimated in a two stage manner. First, the demand is estimated as if the whole market were priced at the uncontrolled rent level and in consideration of the seven demand determinants outlined in the general remarks. The direction of these seven effects are the same as for controlled housing. Second, this level is adjusted to take into account that a portion of the rental demand is satisfied in the controlled sector and to allow for the fact that rental demand has been increased by the existence of the low-cost, controlled sector. The actual consumption of uncontrolled rental housing derived from this two stage process is then compared with the existing uncontrolled rental stock to determine the number of vacant units in this sector.

The rate of rent increase in the uncontrolled sector is determined by the level of vacancies. The lower the vacancy rate, the greater the bargaining power of landlords and the higher rent increases can be expected to be. Conversely, with high vacancy rates, competition among landlords can be expected to lead to lower rates of rent increases.

(d) <u>the ownership market</u>

The supply of ownership units over time will increase with completions of units, decrease with demolitions of units and change according to the net of transfers between the rental and ownership sectors. Completions are taken as the delayed result of starts which, in turn, depend on profitability as determined by the selling price of ownership units, the cost of construction and the cost of mortgage financing. An additional factor might be the availability of government assistance programs. Demolitions are again taken as a fixed proportion of stock, while transfers vary according to the differential between ownership prices and rents on controlled and uncontrolled rental stock.

The demand for ownership housing is again estimated in a two stage fashion. First, ownership demand is estimated on the basis of rental rates equal to those of the uncontrolled market. This demand will:

- increase as uncontrolled rents increase (alternative less attractive);
- decrease as ownership prices increase (higher cost);
- increase as incomes increase (increased affordability);
- increase as inflation increases (tax advantage);
- decrease as mortgage rates increase (higher cost);
- increase as the number of households increase in each age, sex and family status group (demographic need);
- increase as the local labour force expands.

Second, the first stage calculation must be adjusted as a result of the impact of controls in drawing households into the rental market. The resulting level of consumption of ownership housing is then compared to the existing stock to determine the ownership vacancy rate.

The price of ownership housing responds to the tightness of the market as indicated by the vacancy rate (unsold inventory and other vacant units). Again, the lower the vacancy rate, the greater the upward price adjustment.

(e) system dynamics

In addition to the above description of the housing market, it may also be useful to say a few things about the simulation modelling process. 'System dynamics' is an analytical approach to complex problem solving developed by J.W. Forrester. A computer design engineer in his early career, Forrester developed the application of system simulation to progressively more complex social systems.[8] At its best, system dynamics combines the human mind's ability to observe what is happening and to identify primary relationships, with the computer's ability to follow through the complex interaction over time between the various parts of the whole series of relationships.

[8] J.W. Forrester, Industrial Dynamics (Cambridge: M.I.T. Press, 1961); Urban Dynamics (Cambridge: M.I.T. Press, 1969); World Dynamics (Cambridge: Wright-Allen Press, 1971).

The discussion of this section on the general nature of such models draws heavily on Forrester, World Dynamics, pp 13-16.

In this study, the primary relationships for the Ontario housing market have been outlined above. This statement of primary relationships can be stated in the form of mathematical relationships which are then combined with the relevant data base and the specification of 'model parameters'[9] to produce the simulation model. The data base will include both historical data and projections. The model parameters are determined by trial and error through a series of computer runs which are compared against existing historical data, existing empirical relationships and existing economic or social theory. This is not to say, however, that such models tend to produce the results one wants. Indeed, perhaps, the greatest value of the process is that it is a learning experience that serves to refine or even redefine one's view of both elementary and complex processes. What may at first glance seem to be counter-intuitive, may actually be the result of a series of reactions, the full effect of which was hidden to the mind until the computer simulation uncovered the result.

In making a judgement on the model, one should avoid either the extreme of rejecting anything that comes out of a computer or that of accepting anything so produced. A good model is one based on good theory and captures the essence of the social system it represents.

The Toronto Simulation

The simulation model can be used to both assist our understanding of the past and to examine alternative futures. In the next sub-section, the experience of the past five years will be described in the context of the model, while the sub-sections that follow will explore the next five years.

(a) 1976 to 1981

The Toronto housing market exhibited substantial stability from 1976 to 1980 and then experienced a marked change from 1980 to 1981. Both the period of stability and the period of change can be understood in terms of the basic economic forces in our model.

During the period of stability, the various economic factors produced conditions that held vacancy rates in a range between 0.8 and 1.4 per cent, resulted in ownership price increases that were less than the rate of inflation and produced increases in uncontrolled rents that were not greatly different from those in the controlled sector.

In this period, the rate of household formation began to level out in comparison to that of the early 1970's and a shift occurred towards age groups in which ownership housing was the preferred tenure form. These movements represented the effects of the aging of the 'baby boom'

[9]Model parameters or co-efficients are statements of strength of the various factors in relationships.

generation. The labour force in the Toronto area in most years showed fairly modest growth as economic activity in Canada shifted to the energy and resource-rich West. In addition, incomes during this period showed relatively little growth relative to inflation reflecting, in part, the impact of the Anti-Inflation Program from 1976 to 1978 and the lag of wages behind inflation in 1980. All these trends contributed to a lower level of demand increase for housing during this period. A somewhat greater restraining impact could be expected on the rental sector.

Two other factors which were important in changing the relative desirability of ownership and rental housing were the rate of inflation and the level of interest rates relative to inflation. In the 1974 and 1975 period, the then high rate of inflation greatly increased the attractiveness of ownership housing as an investment in that it was an asset uniquely free of capital gains taxation. At the same time, interest rates were low relative to inflation, further stimulating ownership demand. In 1976, both of these factors showed a strong reversal and both factors contributed to the moderate rate of ownership price increase. From 1977 to 1978, these factors worked in the direction of moderate stimulation and in the early part of 1980 they worked in opposite directions with the acceleration in inflation being offset by an increase in interest rates relative to inflation. Overall, these forces were consistent with a lower degree of ownership demand pressure relative to the 1974 and 1975 period.

On the supply side, both the cost of construction and interest rates showed the same pattern, with high rates in 1976, decreases to 1978 and increases from 1978 to 1980. This is consistent with low building activity in 1976, 1979 and 1980 and higher building activity during 1977 and 1978. In the rental sector, this pattern would be reinforced by the impact of government subsidy programs in 1977 and 1978.

Price changes were influenced both by the rent review program and by the forces of demand and supply. The guideline increase for the rental sector in 1976 and 1977 at 8 per cent was roughly equal to the rate of inflation in those years. Thus, no independent stimulus to demand occurred in those years from reductions in the relative price of rental apartments. Indeed, given that rent can increase only once a year under the legislation, the influence of the earlier guideline would be felt into 1978. Starting in late 1977, however, the guideline was lowered to 6 per cent, an amount below the rate of general inflation. From that time onward, rental housing started to become relatively cheaper than other goods and services. This could be expected to serve as a stimulus to demand.

On balance, the forces of supply and demand served to maintain low levels of price increase in the Toronto housing market and maintain fairly stable vacancy rates. Ownership housing prices fell relative to inflation during the period, while controlled rental prices were stable to

early 1978 and fell thereafter. With some level of vacancy and an even higher level of mobility[10] in the rental sector, uncontrolled rents did not rise greatly relative to the controlled sector. The absence of large shifts in the relative prices of controlled, uncontrolled and ownership units implied that no great shifts in demand occurred between sectors in response to changes in price differentials.

In the latter part of 1980 and in 1981 the balanced pattern of the previous few years began to change. The major shifts were:

- the Toronto labour force increased sharply increasing the demand for housing, with a growth in two income households tending to shift demand toward ownership;
- the rate of inflation began to accelerate, increasing ownership demand because of the capital gains exemption effect and increasing demand for controlled rental units given the growing difference between the guideline and the rate of inflation;
- interest rates after increasing in early 1980, fell during the remainder of the year, stimulating ownership demand;
- construction costs fell relative to inflation as the year went on which worked towards a supply increase;
- rental assistance in the form of the Multiple Unit Rental Building tax deferral was terminated, thus eliminating some potential new landlords;
- finally, the interest rate began to turn around before the end of 1980 and rose to unprecedented heights during 1981.

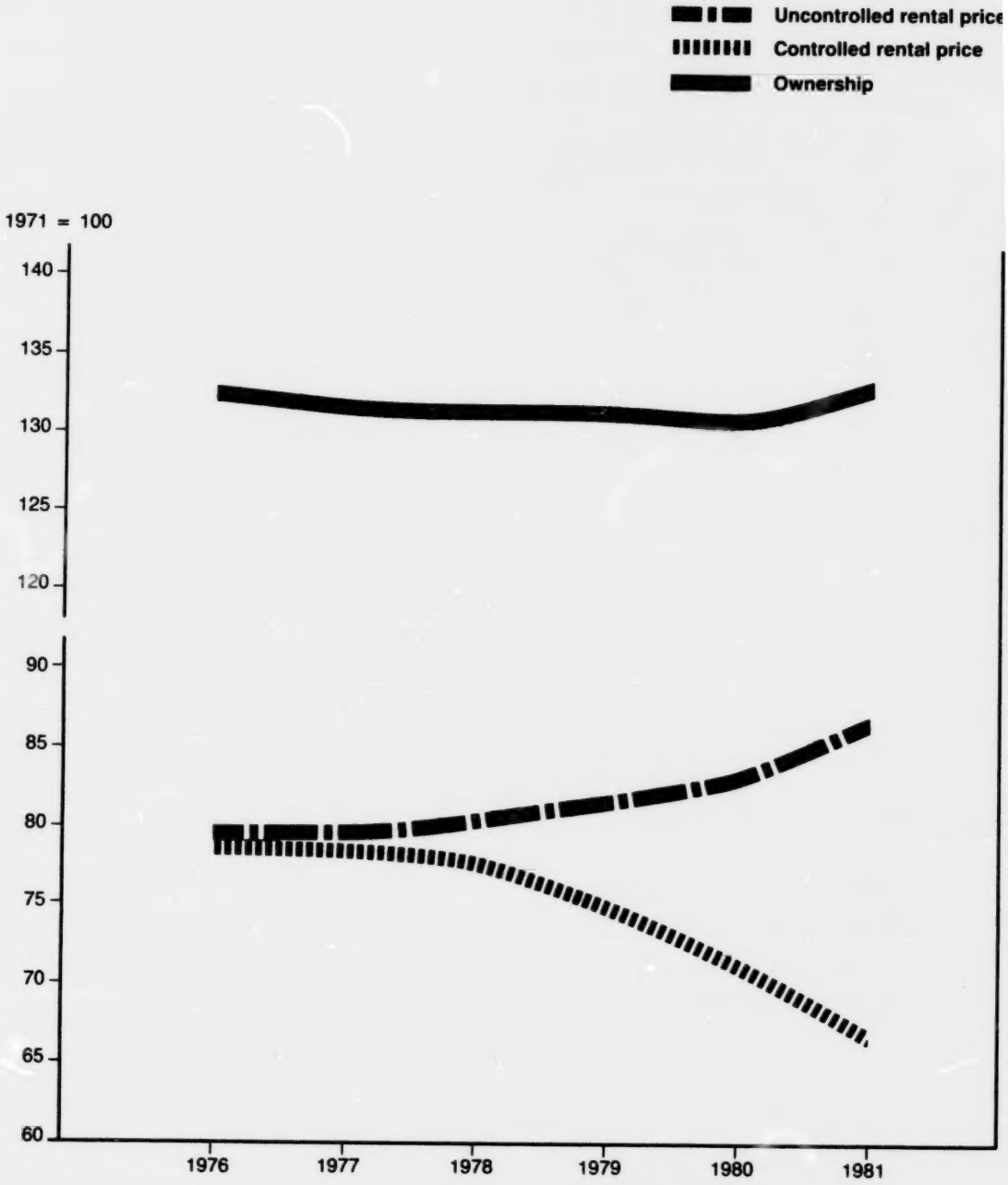
The combination of these factors lead to the ownership price boom of late 1980 and early 1981 (labour force, inflation, low interest period), the brief revival of ownership building in early 1981 (low interest and low construction costs), the subsequent fall in the level of ownership prices (increasing interest rates), a fall in the vacancy rate in the rental sector to below 0.5 per cent (rents fall relative to other prices increasing demand, supply slow due to MURB discontinuation) and rents in the uncontrolled sector began to rise more rapidly (low rental vacancies, some households priced out of ownership market).

The following diagrams serve to summarize the simulation results for prices production and vacancies analyzed above. Figure 2.1 presents the

[10] A Toronto vacancy rate of 0.3 percent (C.M.H.C.) was consistent with a 29 per cent mobility rate in the rental sector over the last year. Rental Market Survey, October, 1981 (Toronto: Ministry of Municipal Affairs and Housing, 1982).

FIGURE 2.1

BASE CASE: TORONTO C.M.A. RENTAL AND OWNERSHIP PRICE INDICES 1976 TO 1981. 1971 = 100



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

changes in controlled and uncontrolled rents along with ownership prices for the period 1976 to 1981. Controlled rents hold steady in relation to the first three years before starting to fall in the last three. Ownership prices have a slow rate of decline relative to inflation over most of the period with a small increase in 1981. Uncontrolled rents were stable until 1977 and then increased relative to inflation.

This pattern produced by the model is similar to that of the actual Toronto housing except that ownership prices fell by somewhat more in relation to inflation in years other than 1981 and in 1981 increased sharply. In large part, this difference reflects the speculative element which played a role in both 1981 and the period just prior to 1976. The short-term speculative element was not included in the model both because of the inherent variability of this element and the fact that the model focuses on the medium-term time period. Thus, the model tends to smooth out the actual experience.

In Figure 2.2, the model's scenario for ownership and rental starts are presented for the 1976 to 1981 period. The model shows increases in production from 1976 to 1978 with a subsequent reduction through 1981 for ownership and some recovery in rental starts in 1981 after a declining trend in the previous two years. The actual experience in Toronto was similar except that ownership production increased rather more in 1977 and less was built in 1978. Thus, the model again smoothed out the production increase relative to actual events.

(b) 1981 to 1986 - Basic Case

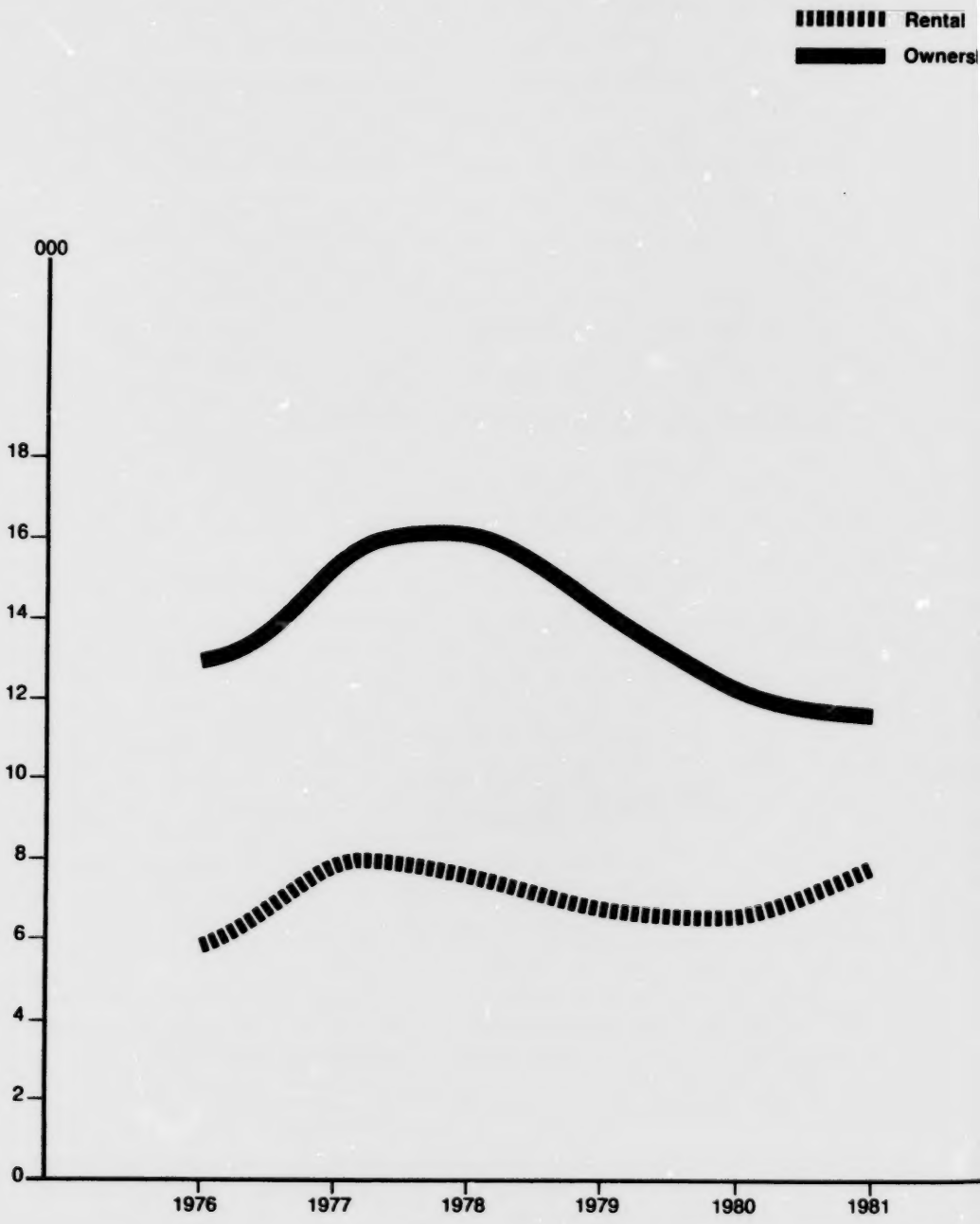
The Basic Case simulation to 1986 is based on a status quo set of policies and a series of assumptions on the basic forces at work in the general economy. The major policy items being held constant are the continuation of the rent guideline at 6 per cent, the extension of the Ontario Rental Construction Loan at current levels and the continued availability of tax write-offs under M.U.R.B.[11] The major economic forces include a deceleration of inflation (down to about 8 per cent in 1985 - 1986), a reduction in interest rates (falling by steps to 12 per cent by 1986), a moderate growth in incomes relative to inflation and a continued gradual decline in demographically based demand.

Given these policy and economic assumptions, the basic pattern of the housing market over the next five years can be traced. In Figure 2.3, the basic scenario is traced for controlled rents, uncontrolled rents, vacancy rates and rental starts for the whole 1976 to 1986 period. Controlled rents show a continuous decline in relation to inflation throughout the period from 1977 to 1986, with the largest declines in the 1980 to 1983 period. This reflects the degree to which the 6 per cent guideline falls below the higher levels of inflation. Hence, controlled

[11] In the absence of M.U.R.B. and possible changes to the Ontario Rental Construction Loan, the assumption is one of the development of financially equivalent assistance.

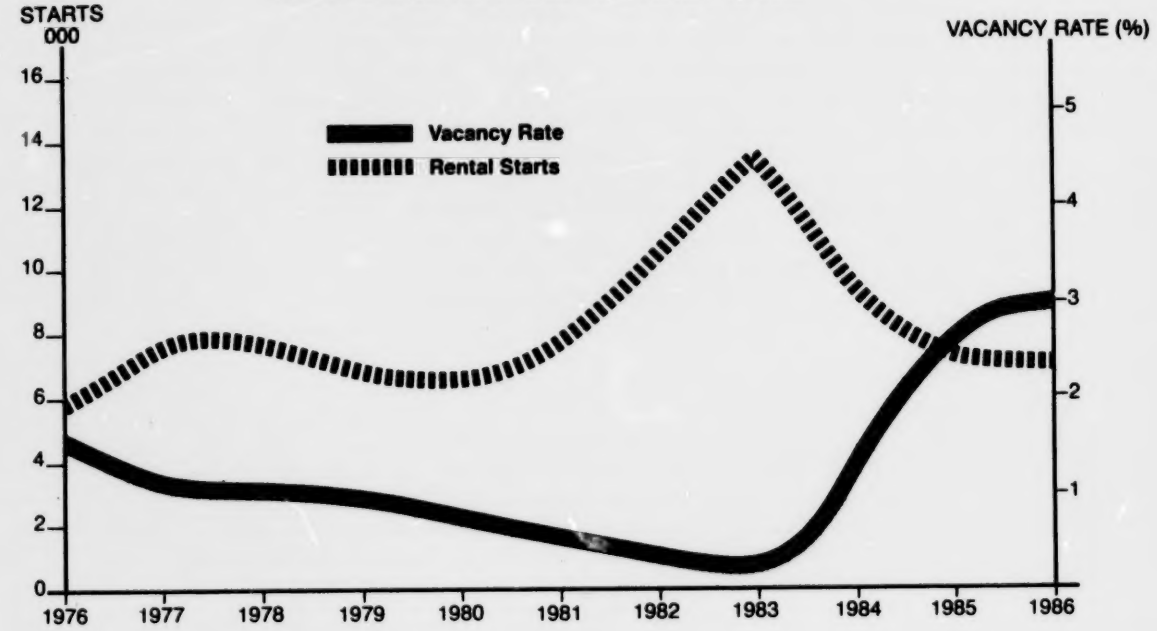
FIGURE 2.2

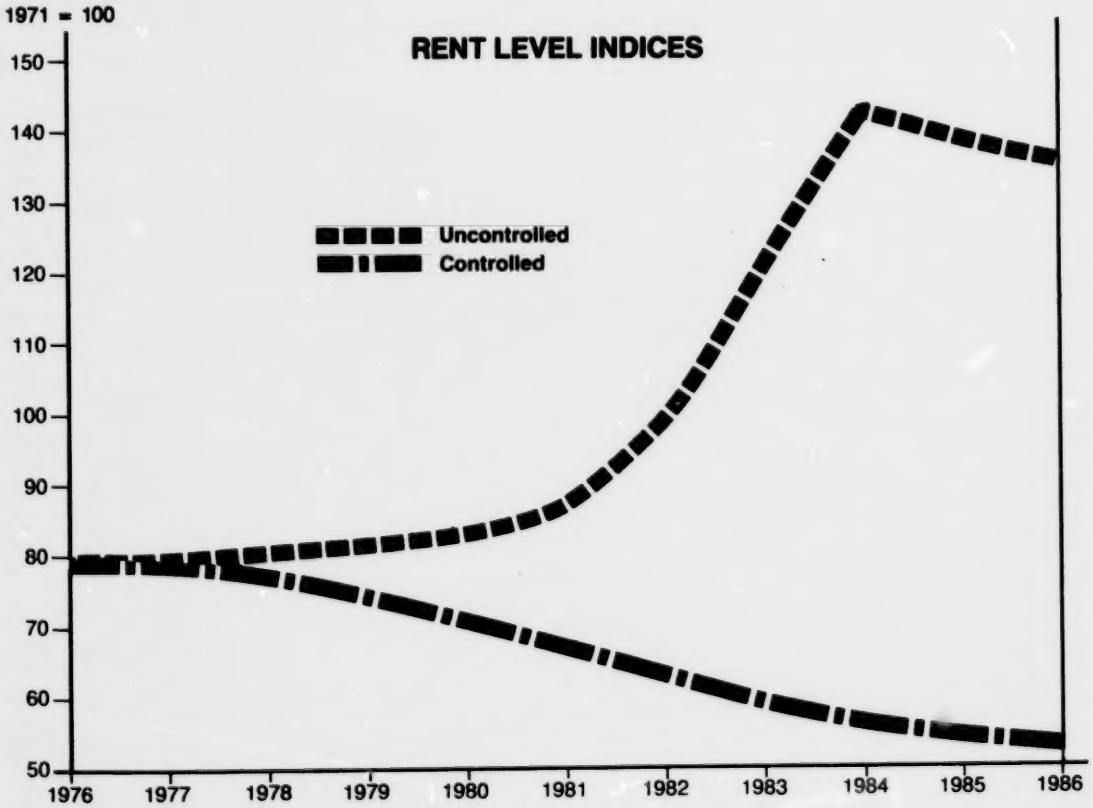
BASE CASE: TORONTO C.M.A. RENTAL AND OWNERSHIP STARTS 1976 TO 1981.



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

FIGURE 2.3
BASE CASE: TORONTO C.M.A.: 1976 TO 1986
RENTAL STARTS AND VACANCY RATE





SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

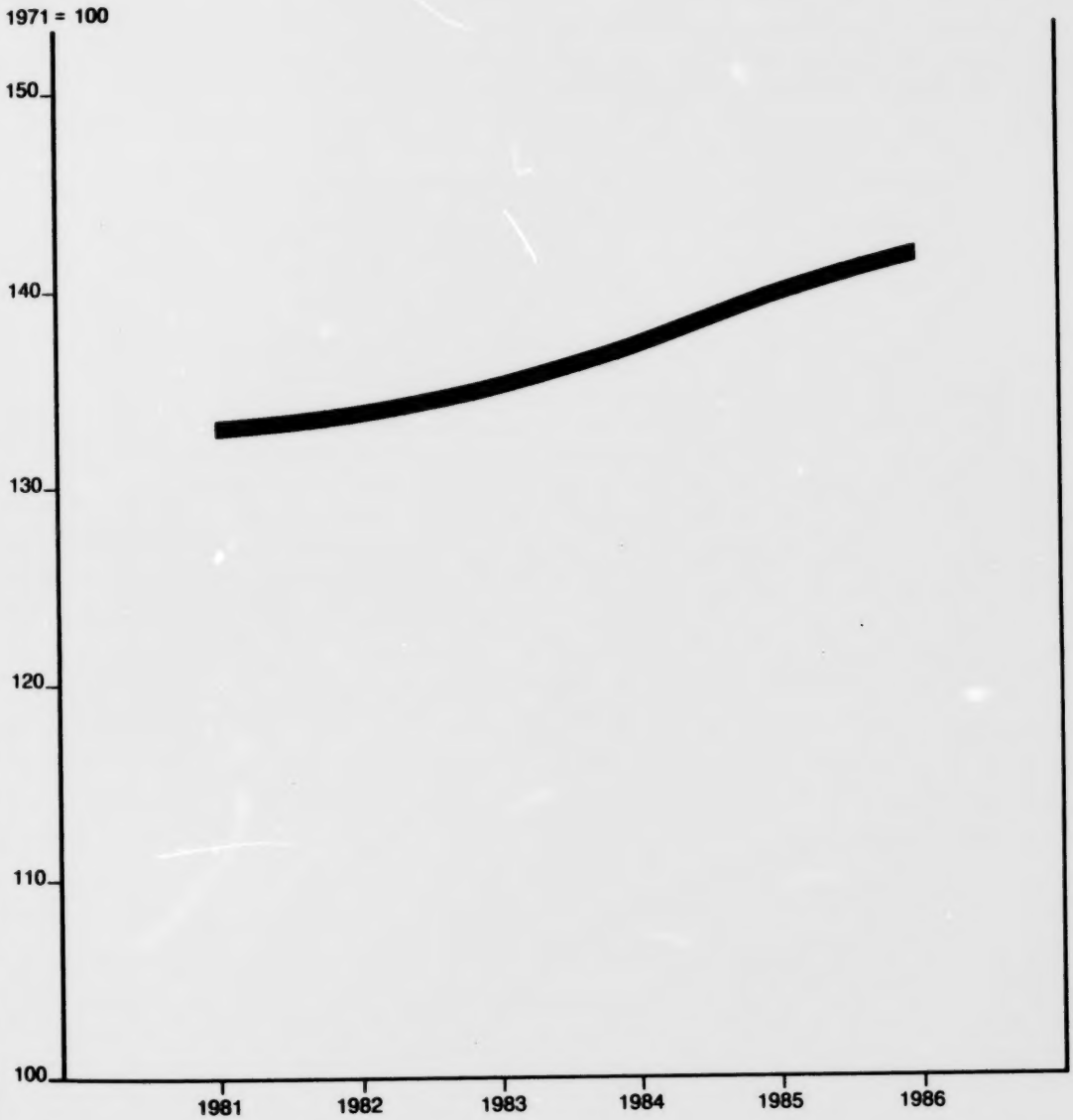
rental housing becomes less and less expensive relative to other prices and incomes throughout the period and this produces a strong stimulation to demand for controlled housing. Indeed, at the controlled price, demand exceeds supply by some 75,000 units by the start of 1981 and by almost 170,000 by the beginning of 1986. In large part, this excess demand which cannot obtain controlled units will be transferred to the uncontrolled rental sector (although some will either enter the ownership market or double up). The demand pressure for rental housing causes vacancy rates to fall until 1983 and also produces a sharp increase in the rents in the uncontrolled sector. Indeed, given the tight rental market, rents in the uncontrolled sector increase by about 14 per cent more than the rate of inflation from 1981 to 1982 and by an average of 20 per cent in 1983 and 1984. This increase in rental prices serves to cause an increase in the vacancy rate partly because of moderate revival in rental starts (high rents and lower interest making new rental projects more economic), but also because of the reduction in demand stemming from the 65 per cent increase relative to inflation in uncontrolled rents.

By 1986, the rental sector has recovered some degree of balance, but with almost two-thirds of tenants enjoying controlled units paying two-thirds of the 1976 rent after adjusting for inflation, while the remaining one-third in uncontrolled units paying 70 per cent more than the 1976 rent level after inflation adjustment. By 1986, those in the uncontrolled sector are paying over two and one-half times the rent of those in controlled units even after adjustment for quality differences. Clearly, two separate classes of tenants and landlords are being created.

In the ownership sector, prices climb over the whole 1981 to 1986 period at a rate one or two per cent above the rate of inflation. (See Figure 2.4.) This increase proves to be largely invariant to what is happening in the rental sector and reflects more the underlying economic and demographic forces at work. Ownership starts fall in 1982 assuming continued high interest rates into that year, but then recover through the remaining period.

FIGURE 2.4

BASE CASE: TORONTO C.M.A. OWNERSHIP PRICES 1981 TO 1986



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

(c) 1981 to 1986 - Alternative 1

The first alternative to be explored will be the extension of controls to post 1976 units. The objective of this would be to attempt to eliminate the disparity between tenants in controlled and uncontrolled units.

The current simulation model cannot be used to provide accurate estimates of the magnitude of the effects of this scenario without modifications to its structure. The theory underlying the model can, however, be used to indicate the major effects. First, units when placed under control will subsequently experience lower rent increases. Second, the lower rent increases will stimulate demand for these units, lowering vacancy rates and producing frustrated demand (people who can't find units). Third, given restraints on future rent levels, the lower economic return on new units will decrease new rental starts initially, with a recovery only taking place when vacancy conditions get so tight that the rent levels on new units have risen substantially (to about $1,000 per month in 1981 dollars for a two bedroom unit).

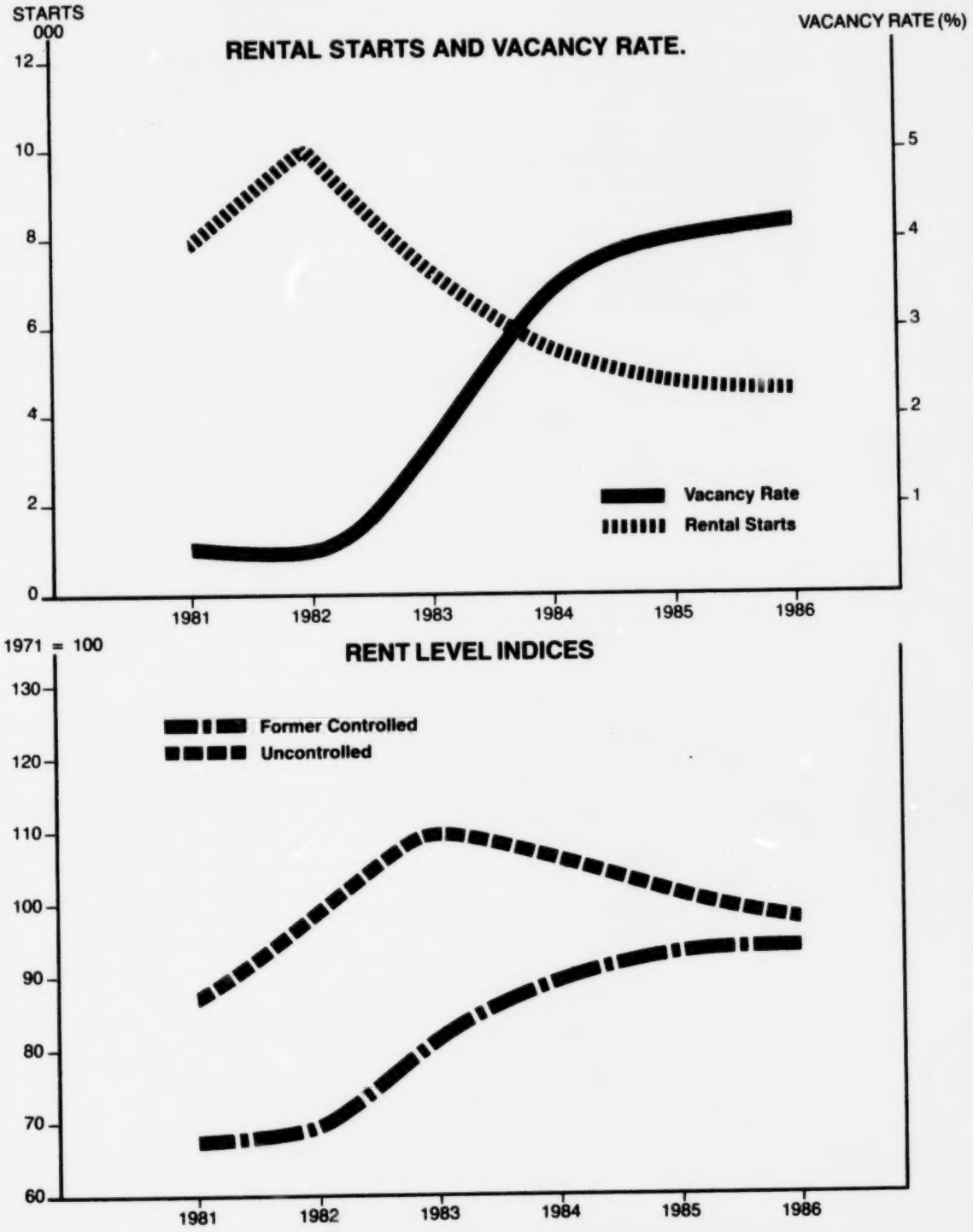
(d) 1981 to 1986 - Alternative 2

A second alternative would be to eliminate the differential between classes of renters by eliminating controls. This is, of course, the polar extreme to the last alternative.

The scenario in the rental market produced by this policy, implemented at the start of 1982, is shown in Figure 2.5. Rents in the formerly controlled sector increase by about 19 per cent above the rate of inflation from 1982 to 1983, but then settle down to more moderate increases. Rents in the uncontrolled sector, on the other hand show a somewhat lower increase from 1982 to 1983 and rates actually fall relative to inflation through 1986. By 1986, formerly controlled and uncontrolled sectors have rents that are roughly the same, after quality differences are taken into account. The impact on vacancy rates in this scenario is fairly strong, rising above 3 per cent by the start of 1984 and it is this increase that serves to moderate rent increases after initial decontrol. Rental starts are lower in this scenario in that the higher rents restrain the rate of increase in demand.

FIGURE 2.5

FULL DECONTROL OPTION: TORONTO C.M.A. 1981 TO 1986



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

(e) 1981 to 1986 - Alternative 3

A third alternative involves a change to the rent guideline. Several possible changes may be considered. To give some indication of the range of results, three scenarios will be presented. A change to 4 per cent, 9 per cent and the rate of inflation.

These three variations are compared to the 6 per cent guideline in the following figures. In Figure 2.6, the real controlled rent is presented. The 6 per cent Base Case has controlled rents falling over 20 per cent relative to inflation from 1981 to 1986. This implies a very substantial increase in demand for these units. The 4 per cent case yields an even larger decrease of over 30 per cent. A 9 per cent rate causes a 6 per cent reduction by 1984 and a less than 2 per cent increase from 1984 to 1986, for a net reduction of 5 per cent. The inflation guideline case produces a 3 per cent increase between 1982 and 1986. This last result is the consequence of setting the guideline on the basis of last year's inflation and the downward trend in this rate.

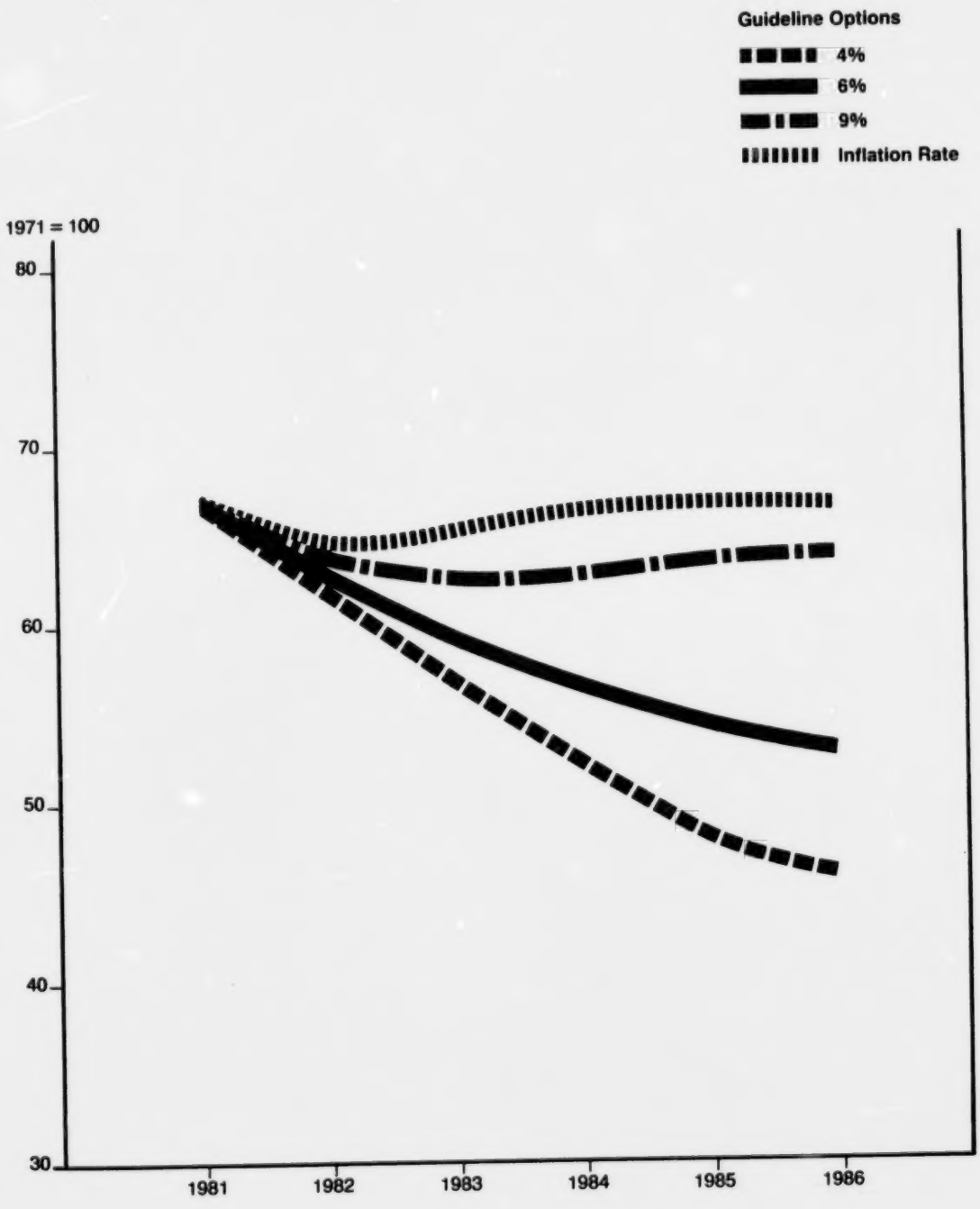
In Figure 2.7, the results for the uncontrolled sector are presented. For the 6 per cent Base Case, the increase of uncontrolled rents is almost 60 per cent over the rate of inflation, with a larger increase before 1984 and a subsequent decline to 1986. The 4 per cent guideline creates an over 70 per cent increase, while the increase for the 9 per cent case is about 45 per cent and in the price guideline case around 40 per cent. Thus, the result is that the greater the fall in the real level of controlled rents, the larger the increase in uncontrolled sector.

Figure 2.8 presents the vacancy rate scenarios under the guideline options. The recovery in each case stems both from the demand reducing effects of the increase in uncontrolled rents and the supply stimulation effects of the same increases.

Thus, while the 9 per cent and inflation rate guidelines both produce a 3 per cent vacancy rate in Toronto by 1986, it must be remembered that while the market as a whole may be in balance, the two rental sectors, controlled and uncontrolled, are not. The controlled sector has a extremely low vacancy rate and the uncontrolled sector a high one. Were decontrol to occur at this point, the gap in rents between these sectors would have to be eliminated, except for quality differences between units. This implies substantial increases in formerly controlled rents and balancing reductions in uncontrolled rents. The larger the gap created by the guideline, the greater the subsequent adjustment.

FIGURE 2.6

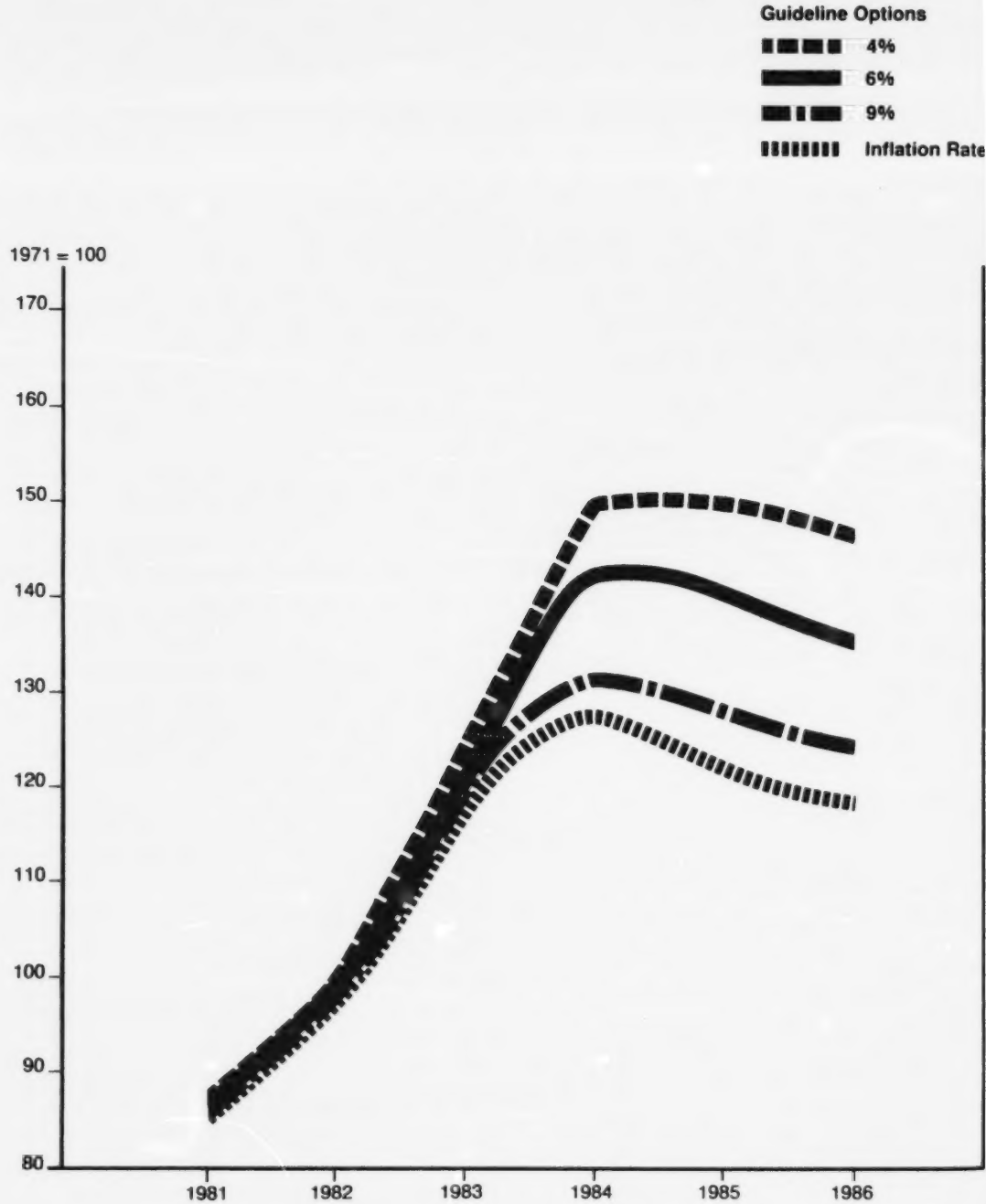
CHANGES IN RENT REVIEW GUIDELINE: TORONTO C.M.A. CONTROLLED RENT INDEX: 1981 TO 1986



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

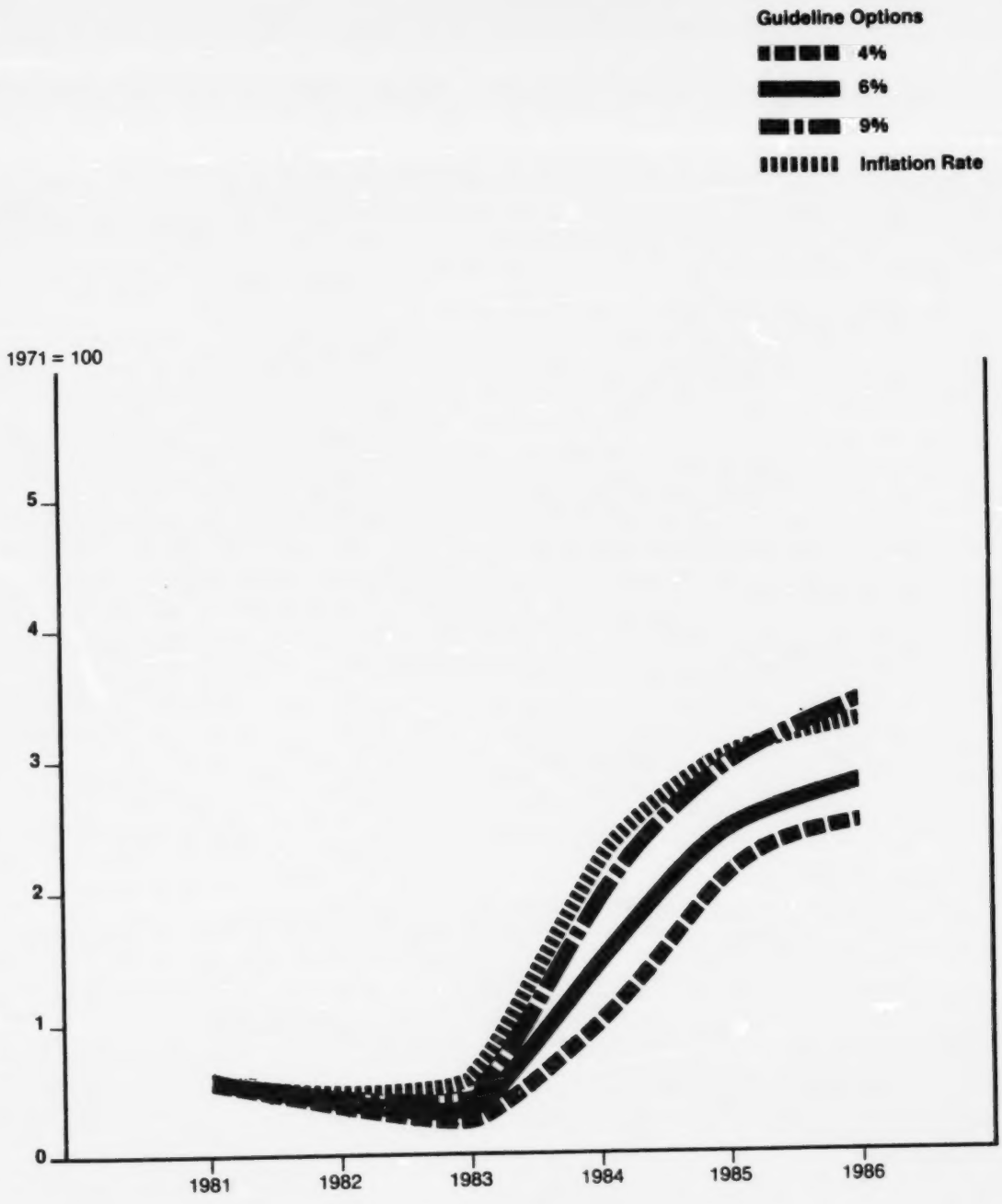
FIGURE 2.7

CHANGES IN RENT REVIEW GUIDELINE: TORONTO C.M.A. UNCONTROLLED RENT INDEX 1981 TO 1986



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

FIGURE 2.8
CHANGES IN RENT REVIEW: GUIDELINE: TORONTO C.M.A. VACANCY RATE: 1981 TO 1986



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL.

The London Simulation

(a) 1976 to 1981 - Base Case

The major differences between the London and Toronto housing markets over the past five years are captured by the model. In the rental market, London developed a much higher vacancy rate by 1979 and 1980 with the result that uncontrolled rents did not increase relative to controlled rents as competition, rather than rent review, limited increases. In addition, the over supply of rental housing units led to a fall off in starts by 1980.

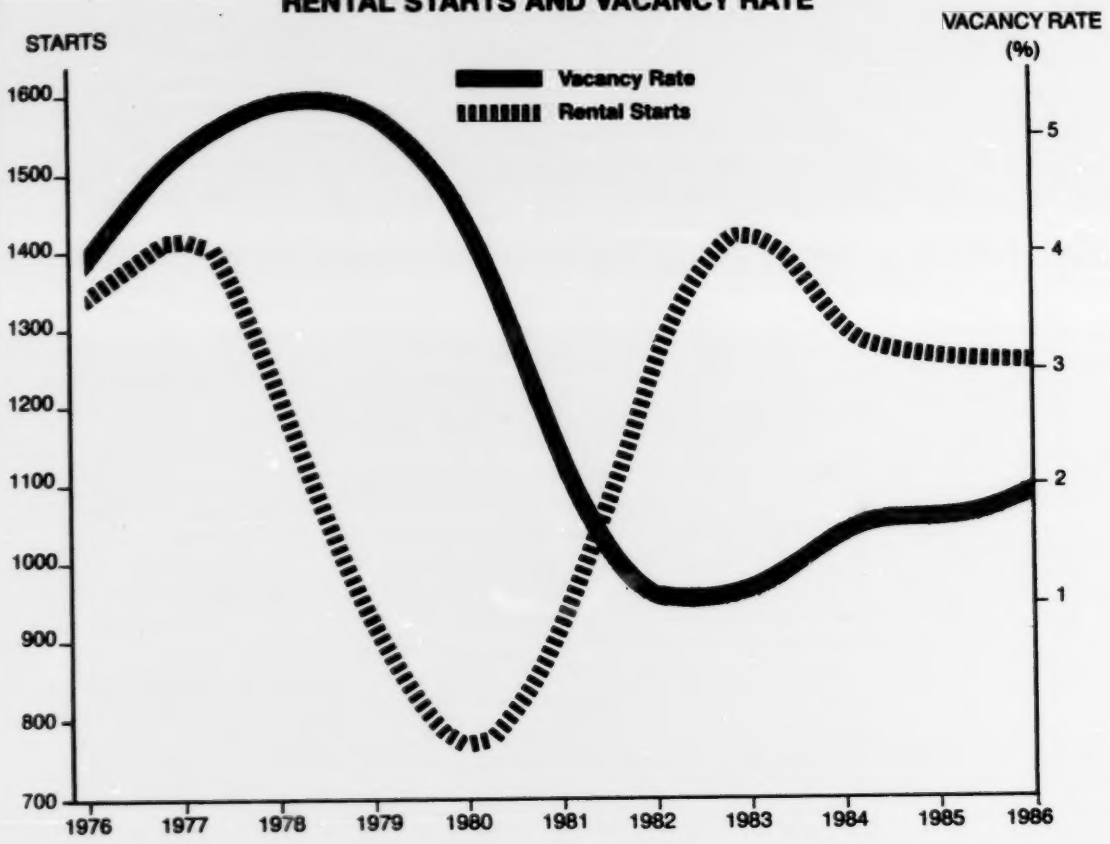
In the ownership market, prices fell relative to inflation over the full period with a corresponding reduction in ownership starts in the latter part of the period.

(b) 1981 to 1986 - Base Case

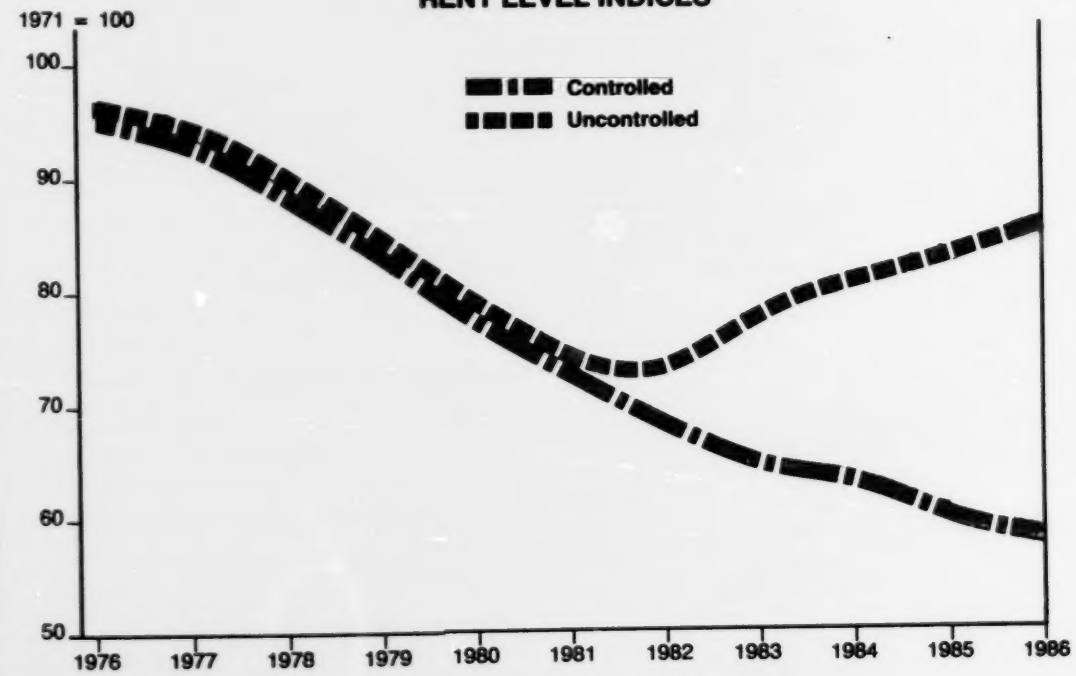
The projections for London indicate that the high vacancy rates of recent years will not persist. The demand from both demographic and economic growth, combined with lower levels of rental starts, will produce a fall in vacancy rates to one per cent in 1982. This will start to produce increases in uncontrolled rents that are a few percentage points greater than the general rate of inflation in 1983 and 1984. This increase, when contrasted with the 6 per cent guideline increase in the controlled sector, will begin to open up a gap between rents in the two sectors. By 1986, rents in the uncontrolled sector will be about 40 per cent higher than on units subject to controls even after allowing for adjustment to reflect quality differences in the units. Vacancy rates after falling to 1 per cent in 1982, recover moderately in later years due to both the demand reducing effects of higher uncontrolled sector rents and to the supply stimulus provided by these rents. Figure 2.9 illustrates the changes described.

FIGURE 2.9

BASE CASE: LONDON C.M.A.; 1976 TO 1986
RENTAL STARTS AND VACANCY RATE



RENT LEVEL INDICES



SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL

(c) 1981 to 1986 — Decontrol

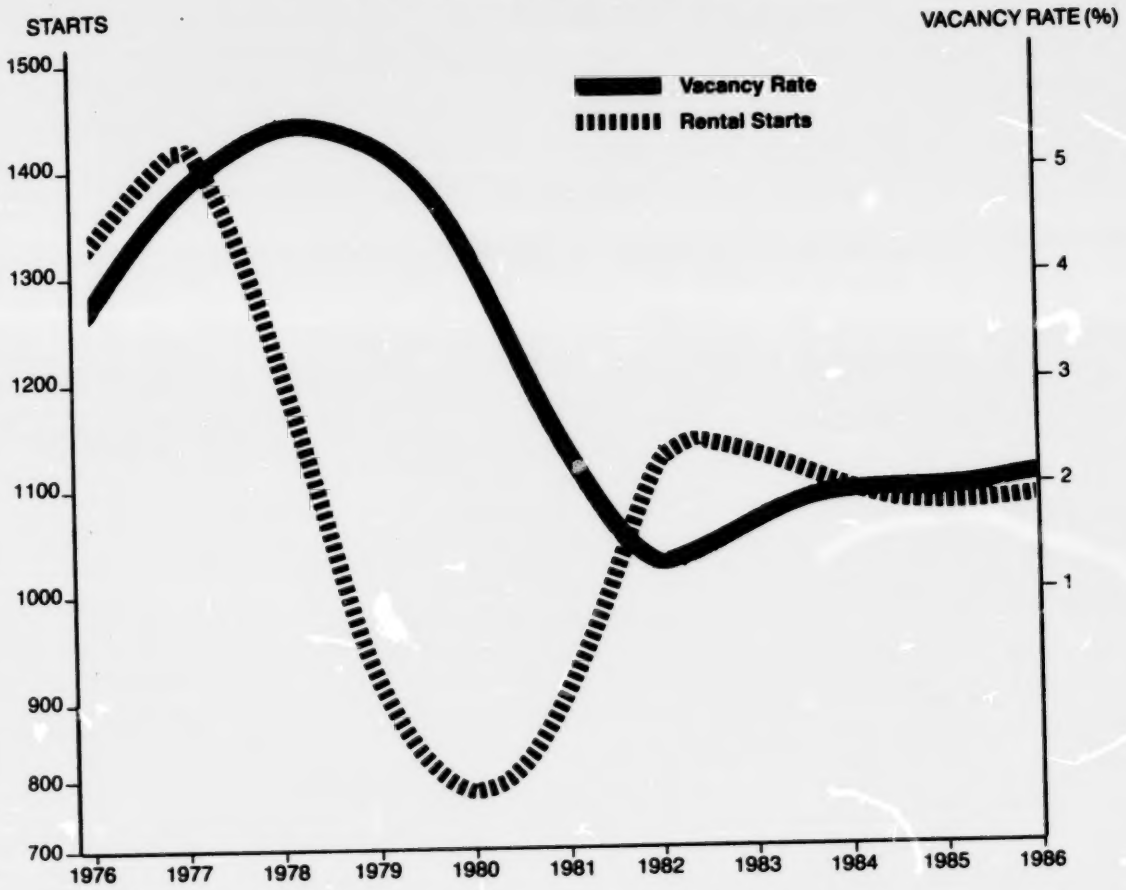
If rent review were removed in London at the start of 1982, there would be relatively minor impacts in comparison to the Toronto market. Rents in the controlled sector would increase by 3 or 4 per cent relative to inflation in 1983, while rents in the uncontrolled sector would increase by about 1 per cent above the rate of inflation. This contrasts with increases relative to inflation in the 20 per cent range in Toronto in the same year. The rent increase on controlled units in London would return rents by early 1983 to the same level of real rent as existed at the start of 1981. From 1983 to 1986 both controlled and uncontrolled rents remain almost stable in relation to inflation and the vacancy rate stablizes in the 2 per cent range.

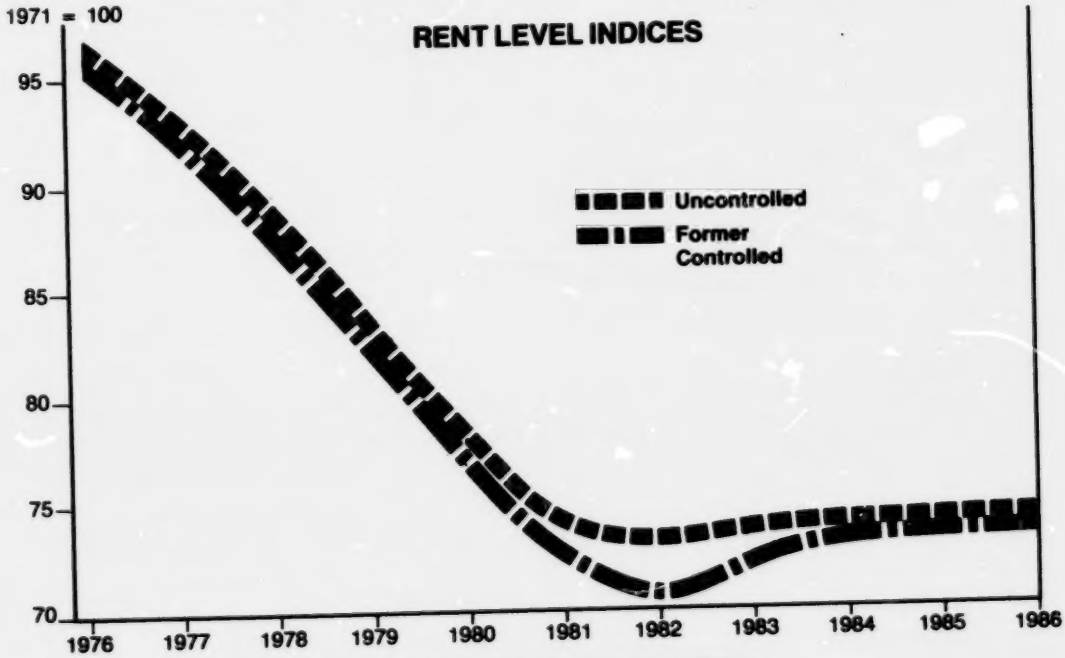
Figure 2.10 illustrates the scenarios for decontrol for London.

(d) 1981 to 1986 — Changed Guidelines

As in the Toronto case, decreases in real controlled rents create greater upward pressure on uncontrolled rents, whereas, increases in the guideline relieve pressure on the uncontrolled sector. The impact on rents of a 4 per cent guideline and a guideline equal to last year's inflation are presented in Figure 2.11. The 4 per cent guideline produces an almost 20 per cent increase in uncontrolled rents relative to inflation by 1986, while lowering controlled rents by about 30 per cent relative to inflation. Vacancy rates are in the 0.9 to 1.6 per cent range (not shown). In the inflation guideline case, controlled rents increase by about 1 per cent a year relative to inflation, while uncontrolled rents increase by about 2 per cent relative to inflation in the first year and then decline by a small amount relative to inflation in the following years.

FIGURE 2.10
FULL DECONTROL OPTION: LONDON C.M.A.; 1976 TO 1986
RENTAL STARTS AND VACANCY RATE

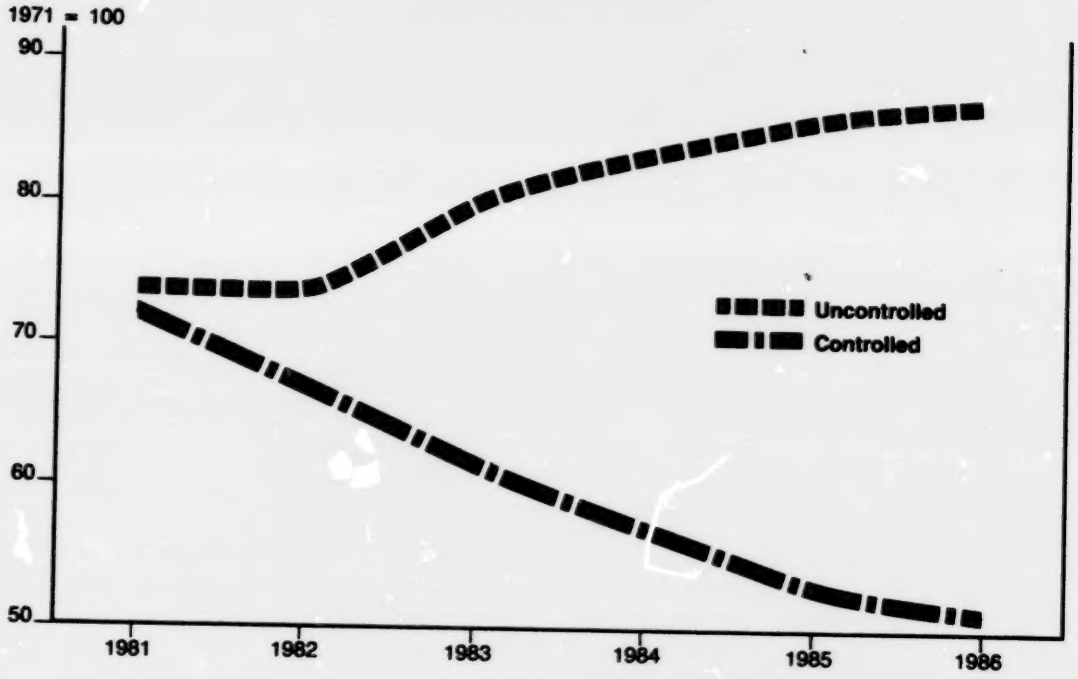




SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL

FIGURE 2.11
CHANGES IN RENT REVIEW GUIDELINE
LONDON C.M.A.
RENT LEVEL INDICES: 1981 TO 1986

4 PERCENT OPTION



INFLATION RATE OPTION

SOURCE: ECONALYSIS CONSULTING SERVICES: SIMULATION MODEL

CHAPTER 3 — Maintenance

One of the frequently mentioned effects of rent controls is the impact on maintenance.[1] It is worth knowing if a reduction in maintenance levels is occurring in Ontario. This is especially so given that the quality of housing stock changes slowly over time and rent review has been in effect for only six years.

For several years, 1976 to 1979, the Ministry included questions on the general state of maintenance in its annual rent survey. The findings invariably were that over half of the tenants found maintenance to be good or very good and about a quarter more found it adequate, with only 10 to 20 per cent rating it poor or very poor. In addition, most tenants did not notice any year-to-year change in the quality of maintenance and of the minority who did, more indicated improvement than deterioration.

These results are typified by the 1979 data on levels of maintenance, Table 3.1, and perceived changes in the level of maintenance, Table 3.2.

While this previous work seemed to indicate that little, if any, deterioration was occurring, some doubt existed as to whether these tenant observations were accurately measuring the maintenance situation. The 1979 Rental Market Survey noted that there existed a high degree of inter-city relationship between level and changes in maintenance on the one hand and variables such as rent increases, rent levels and population size on the other.[2] This raised the possibility that maintenance responses were actually representations of factors other than the condition of the building. A survey was initiated by the Ministry to further explore the issue of measurement of maintenance. The survey was conducted by Social Policy Research Associates.

The sections that follow will present the results of the survey as well as several important issues. First of these is the economic logic behind the prediction that maintenance will decrease under controls. Second is how maintenance may be defined. Third is specific factors related to the conduct of the survey.

[1]See, for example, Richard Arnott, Rent Control and Options for Decontrol in Ontario, (Toronto: Ontario Economic Council, 1981) chapter 3 and works cited therein and chapter 4.

[2]Rental Market Survey, October, 1979 (Toronto: Ministry of Housing, 1979) p.45-47.

Table 3.1

Current Quality Of Maintenance And Services
- Tenant Perception -

Municipality	Very Good (%)	Good (%)	Adequate (%)	Poor (%)	Very Poor (%)	Total (%)	Sample Size
Metro Toronto	28.3	27.3	28.0	10.3	6.1	100	735
Ottawa	30.0	30.3	25.9	9.6	4.2	100	711
Hamilton	28.5	30.1	26.0	9.4	6.0	100	562
Windsor	28.4	30.4	25.3	10.5	5.4	100	704
London	33.1	32.9	23.7	6.5	3.8	100	840
Thunder Bay	28.6	35.9	21.4	10.3	3.8	100	789
Sudbury	37.8	31.8	20.0	6.4	4.0	100	905

Source: Ontario Ministry of Housing Rental Market Survey, 1979.

Table 3.2

Change In Level Of Maintnenance And Services (Non-Movers)
- Tenant Perception -

Municipality	Improved A Lot (%)	Improved A Little (%)	Same (%)	A little Worse (%)	A Lot Worse (%)	Total (%)	Sample Size
Metro Toronto	4.3	13.8	67.8	9.2	4.9	100	465
Ottawa	5.1	12.4	73.6	7.5	1.4	100	429
Hamilton	5.9	11.9	69.5	9.0	3.7	100	354
Windsor	6.3	16.9	67.8	6.8	2.2	100	366
London	5.6	15.7	70.1	7.0	1.6	100	428
Thunder Bay	3.8	15.4	73.9	5.1	1.8	100	396
Sudbury	7.4	17.9	67.8	5.8	1.1	100	537

Source: Ontario Ministry of Housing Rental Market Survey 1979.

The Economics of Maintenance

The economic rationale for cutbacks of maintenance under controls is fairly simple to present. If rent control places a limit on the rent earned from a unit of rental housing then landlords can increase profits only by lowering costs. In that inflation quickly erodes the value of existing profits, one can readily understand that landlords might have an interest in cost saving measures. It is often thought that maintenance is the easiest area in which to cut costs because its level is not fixed in the same sense as mortgage payments or taxes, as immediately noticeable as other cuts in services (e.g., closing swimming pools) or subject to other regulation (e.g., heating). Hence, it is felt that controls on rents will produce decreases in maintenance levels.

It is important to note that the above argument applies where limits are placed on unit rents rather than rent for a level of housing services. If rent levels are tied to the level of services provided, then revenues would decrease with cutbacks of services.[3] If set at the right level such a link between services and revenues could prevent any decline in services. In fact, most rent control legislation, including that for Ontario, does make provision for rent changes in relation to service charges.[4] However, as a practical matter it is impossible to fully police, both because not all units come to review and because it is extremely difficult to establish what the previous level of services happened to be.

If landlords can vary service levels in order to increase profits or to reduce losses, this can be used as a mechanism that shifts the impact of rent review from landlords to tenants. Indeed, rent per unit of service may actually increase under rent review.[5] In addition, if the quality of units falls by enough this may serve to eliminate the gap between rents being charged and the rents that would exist in the absence of controls. Thus, the housing shortage would be measured not so much in terms of number of units, but rather in the form of housing deterioration.[6] This would require modification to the analysis of the preceding chapter if maintenance deterioration were important.

Finally, one should note that it is possible that maintenance is only one of many areas that may be the subject of reductions. Despite the argument presented above, it is possible that other areas could be chosen for cost savings: management overhead could be reduced; extra services curtailed; energy efficiency increased; debt paid off rather than

[3]The importance of this distinction was noted by Mark Frankena, "Alternative Models of Rent Control," Urban Studies (1975) pp 303-308.

[4]The Residential Tenancies Act, 1979, Sections 131 and 132.

[5]As noted in Arnott, pp 35-36.

[6]Arnott, pp 35-36.

refinanced at higher rates and municipal taxes reduced by means of re-appraisal of building value. The next chapter on Rate of Return discusses some of these possibilities.

What is Maintenance?

Everyone knows what maintenance is until they have to define it. A general definition is not that difficult. Maintenance may be defined as:

> "Work undertaken in order to keep or restore every facility, i.e., every part of a site, building, and contents to an acceptable standard...It is synonymous with controlling the condition of a building so that its pattern lies within specified regions."[7]

The real difficulty comes in defining it for purposes of measurement. Unlike bushels of wheat or tons of steel or even units of housing, it is not apparent exactly what is being measured and how the units are to be defined. This section will deal with some of the major issues and the resolution chosen for this study.

To start with, maintenance can be defined in terms of input (people, equipment), output (clean floors, repaired elevators), or impact (tenant or landlord satisfaction). Input measures have the advantages that they are objective, easy to specify and can readily be converted into monetary equivalents for the purpose of aggregation. There are, however, disadvantages that more than offset the positive features. First, when it is claimed that maintenance deteriorates under rent review, the meaning is not normally that fewer resources are used, but rather that there is physical deterioration in the building. Second, inputs can be reduced through increased efficiency rather than reductions in services. Third, there are problems in identifying maintenance expenditures among the various expense categories in landlord accounts. Fourth, data access was anticipated to be more difficult if expenditures are being viewed. On balance, the input measures were rejected as not fully adequate for our purpose.

Impact measures would have the advantage of monitoring the level of concern on the part of tenants or landlords. As such, they would be mostly subjective, but it can be argued that one only has a problem if people feel it is a problem. On the other hand, it does seem important to know whether a maintenance problem is real (actual deterioration) rather than merely psychological (perception of deterioration). This is especially so given the high degree of correlation between maintenance and other variables noted above, in reference to the Ministry's Rental Market Survey. And, again, it would seem that the claims are that rent review creates a real deterioration in maintenance rather than merely a decrease in people's feelings about it.

[7] R. Lee, Building Maintenance Management (London: Crosby, Lockwood Staples, 1976) p.8.

The focus on the study, then, was on the output measurement of maintenance. While some information was collected on the input (see Chapter 4) and impact measures (general questions included in this Chapter), most information related to output measures.

The choice of output, while conceptually the most appropriate, was not without its difficulties. The first strategic problem relates to the question of the subjectivity or objectivity of the results. To minimize the subjective element, two basic strategic decisions were made. First, every attempt was made to focus respondents on specific maintenance results. While general questions on maintenance levels were still asked as an aid to aggregating evaluations, respondents were also asked a series of questions relating to specific items which were either objective in nature (e.g., "plumbing system broken down or shut down so that tenant was without water for six hours or more in the past year") or for which specific guidance was given as to classification to be used in making judgements.

Second, to further explore the remaining subjective element the survey was designed to gain a number of perspectives in each building. In fact, there were three surveys conducted: a landlord survey, a tenant survey and a site visit by the consultant. For about one-half of the buildings in the sample all three surveys were performed, while the other buildings had both landlord and site visit components. The tenant survey included a random selection of tenants from all parts of the building. If all three responded similarly it would give evidence that objective considerations dominated in evaluations.

The second major issue to be addressed in defining maintenance was the determination of what items should be included in the survey. The basic strategy consisted in extensive enumeration of possible aspects of maintenance. The enumeration proceeded from a knowledge base that included:

- discussions with experts on building maintenance, landlords, tenants and others;
- information on maintenance schedules provided by Ontario Housing Corporation and others;
- manuals prepared by industry sources;[8]

[8]Institute of Real Estate Management, How to Write an Operations Manual: A Guide for Apartment Management, (Chicago: Institute of Real Estate Management of the National Association of Realtors, 1978).

- studies produced by the Urban Institute;[9]
- studies produced by the U.S. Department of Housing and Urban Development;[10]
- extensive discussions between the consultant and the Ministry.

These concepts were further refined in the process of a pretest conducted in November and December of 1980. Given the extensive listing of possible items, a review was made to combine closely related items (e.g., paint and wallpaper) in order to reduce the overall length of the survey instrument. The items included in each of the surveys can be classified into five categories as indicated in Figure 3.1.

Figure 3.1

Maintenance Areas Covered in Each Sub-survey

	Site Visit	Landlord	Tenant
Janitorial	X	X	X
Major Systems		X	X
Cosmetic	X	X	X
Requests		X	X
Preventive		X	
Number of Buildings	307	307	164

[9]Jeanne E. Goedert and John L. Goodman, Jr., Indicators of the Quality of U.S. Housing (Washington, D.C.: The Urban Institute, 1977); John L. Goodman, Jr. Causes and Indicators of Housing Quality (Washington, D.C.: The Urban Institute, 1976); Morton Isler, Keys to Successful Housing Management (Washington, D.C.: The Urban Institute, 1974); Robert Sadacca, Suzanne B. Loux, Morton Isler, Margaret J. Drury, Management Performance in Public Housing (Washington, D.C.: The Urban Institute, 1974).

[10]Annual Housing Survey Questionnaire, conducted by the U.S. Department of Housing and Urban Development; Resident Satisfaction in HUD Assisted Housing: Design and Management Factors (Washington, D.C.: Office of Policy Development and Research, HUD, 1979). (This study includes survey instruments developed by the Housing Research and Development Program, University of Illinois).

The third strategic issue related to the method of combining the many specific observations on maintenance into an overall evaluation. A possibility was simply to present all of the results without any aggregation and let readers draw their own conclusions. This method was rejected given the extensive and complex nature of the individual results. It was decided to create an index and to provide weights from an analysis of the survey results itself. Accordingly, the results of the survey were utilized to construct maintenance indices.

An index may be used as a summary measure that simplifies the understanding of a many-faceted phenomenon. As B. Rutherford explains:

> "Although an index is constructed from variables which are not identical, each variable should reflect some part of the common attribute, a single underlying phenomenon. By combining multiple indicators of a common phenomenon a composite index results which better reflects that phenomenon than any single indicator, as random errors cancel out. Thus, a condition for a highly reliable index is that it be composed of items which each express some aspect of a common phenomena."[11]

A familiar example of such an index is the Consumer Price Index which is used to convert the thousands of individual increases in prices of particular goods into a statement of price changes in the overall economy.

In preparing an index of maintenance, four major steps can be identified. The first step was to separate out from questionnaire responses the items that dealt directly with maintenance output. The second step in the analysis was to perform a 'factor analysis' on the candidate variables. Factor analysis is a statistical technique that can reduce a large number of items into a small number of factors with which the individual items are highly related. The third step was to identify the strength of the relationship between the two factors identified and each of the candidate items. The fourth step was to sort through the individual items to eliminate items that had a low degree of linkage to maintenance in general or the two factors in particular.[12]

Survey Design

In order to fully appreciate the nature of the results, some information on the survey designs is required. More detailed information on the

[11]Brent Rutherford, "The Development of Measures to Express the Level of Maintenance in Rental Apartment Buildings" (Toronto: Ministry of Municipal Affairs and Housing, 1981) p.6, (typewritten).

[12]For additional detail see B. Rutherford.

design is contained in the consultant reports on this project.[13] The separate Ministry report will provide the rationale for each of the design features described in this report.

First, the landlord survey involved personal interviews, the tenant information was gathered by means of a mail survey, while the site visits were conducted by personnel employed by the consultant.

Second, the study was limited to buildings of 20 units or more in Metropolitan Toronto.

Third, the buildings were selected on the basis of random probability sampling. The sample was stratified by age and size of building in order to allow for measurement of performance by these variables.

Finally, most of the questions focused on current levels of maintenance, although questions were also included on the changes in maintenance over time.

Validity and Reliability

In the sections that follow, the results of the survey will be presented with a focus on four overall issues:

- what is the general state of maintenance?
- what is the evidence on changes in maintenance?
- what kinds of buildings have problems?
- what are the reasons for the problems?

The responses that are presented below are put forward with considerable confidence given the high response rates experienced and given the strong performance of the data on standard tests of reliability and validity. The response rate for the landlord survey was 74 per cent and it was 77 per cent for tenants. Site visits were conducted on 100 per cent of the buildings for which landlord interviews were obtained. A study of non-response of landlords indicated that for most items examined no significant differences in responses were observed and of the four items for which differences were observed, two showed better maintenance and two showed worse.[14]

[13]Social Policy Research Associates, "A Study of Maintenance of Rental Housing in Metropolitan Toronto: Phase II Survey Design," (Toronto: Social Policy Research Associates, March 9, 1981) (typewritten); "Technical Report on a Survey to Assess Levels of Maintenance in Apartments of 20 units or more in Metropolitan Toronto: Assessing Reliability and Validity," (Toronto: Social Policy Research Associates, October, 1981) (typewritten).

[14]Unfortunately the mail strike terminated the non-response study before full results were in. Analysis based on 48 percent response.

Validity and reliability are terms used by statisticians to describe the quality of data. Validity is defined as the extent to which a measure provides indications of what it is intended to measure and not other factors. It, therefore, provides one with an indication of the objective nature of the evidence. Reliability is defined as the extent to which a measure is dependable in the sense of producing similar answers each time it is used. Hence, it demonstrates consistency.

Validity and reliability were explained in four ways. First, reliability was examined by retesting a number of questions on 38 landlords, 109 tenants and 53 site visits to ensure that answers were consistent with initial testing. Second, the responses to questionnaires were tested for internal consistency. If answers displayed similarities this increased confidence that aspects of the same phenomena were being observed and that answers were consistent. Third, for the tenant questionnaire, the fact that many tenants in a building were answering the same question allowed comparison for consistency of response. Fourth, the three surveys were compared for consistency between different types of respondents - landlord, tenant and site visitor. The results of these tests generally showed the data to have a high degree of reliability and validity. Full details on the results are available in the above mentioned reports by Social Policy Research Associates and Dr. B. Rutherford.

The General State of Maintenance

Landlords, tenants and site visitors were asked to provide an overall rating of the apartment building maintenance. These questions were posed after the other more detailed questions related to specific maintenance items. As such, one may suppose that these ratings were made after an opportunity to reflect on the many aspects of the issue.

In Table 3.3, the weighted ratings are presented for landlords, site visitors and tenants on a building-by-building basis. As can be seen from Table 3.3, all three surveys agree that overall maintenance levels are good or very good, with poor or very poor ratings being minority views.

Not only do the aggregated global ratings of all three surveys largely agree, there is also a high degree of similarity of response for individual buildings. The Pearson correlation co-efficients are all significant at the 1 per cent rating for the three sets of observations. That is, there is less than a 1 per cent probability that the relationships between the observations are due to chance.

Table 3.3

Weighted Global Maintenance Ratings
Comparison of Site, Tenant and Landlord Observations

Rating	Site	Landlord	Tenant*
		(Per Cent)	
Very Good	11.7	31.3	31.7
Good	69.1	61.2	50.1
Poor	17.0	4.0	18.2
Very Poor	0.6	2.0	0
No Response	1.5	1.6	0
	100.0	100.0	100.0

*Rating: Conversion of five point scale to four points.

Very Good to Good; Good to Adequate; Adequate to Poor; Poor to Very Poor.

Note: Categories may not equal 100% due to rounding.

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

In Table 3.3, as noted, the tenant views were reported on a building basis. For purposes of comparison the actual 5 point scale was reduced to 4 points. Table 3.4 provides both the distribution of unweighted individual tenant responses and the distribution of weighted responses by building on the actual 5 point scale. As can be seen, the findings in this Table largely confirm the qualitative judgement from Table 3.3.

From the global ratings, one must conclude that maintenance levels in Toronto buildings of 20 or more units are considered good or very good by a substantial majority of tenants, landlords and independent site visitors.

Table 3.4

Five Point Tenant Global Maintenance Ratings

	Weighted Tenant View by Building	Unweighted Tenant View by Building	Unweighted Individual Tenant Responses
		(Per Cent)	
Very Good	7.8	9.8	27.4
Good	47.8	50 6	32.5
Adequate	38.0	34.8	23.6
Poor	6.5	4.9	9.9
Very Poor	0.0	0.0	2.6
Not Available	0.0	0.0	4.0
	100.0	100.0	100.0

Note: Categories may not equal 100% due to rounding.

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

Changes in Maintenance

Both tenants and landlords were asked to provide observations on changes in specific types of maintenance over time. Because of high tenant mobility, only one year comparisons were asked of tenants, while landlords were questioned on both one and five year changes. Site visitors, of course, could not be asked to provide evidence on changes over similar periods.

In Table 3.5, tenant perceptions are given. It can be seen that in about 90 per cent of all buildings, the average tenant response was that maintenance was the same as a year ago. The remainder of the sample was split between those buildings with tenants on average believing maintenance had improved and those where the feeling was that there had been deterioration. The differences between those buildings with tenants believing it was better and those indicating that it was worse are small and not statistically significant. Looking at the actual unweighted responses on changes in janitorial care, 587 tenants said there had been improvement, 419 that there had been deterioration and 3,102 that things were the same. That is, 75.5 per cent of respondents said there had been no change, 14.3 per cent indicated better maintenance and 10.2 per cent worse maintenance. Again, the differences between those believing things were better are not significantly different than those believing they were worse.

In Table 3.6, landlord perceptions are presented for changes over the last year.

Table 3.5

Tenant Perceptions of Changes in Maintenance in Last Year

Question	Better	Same	Worse	Total
	(Per Cent of Buildings)			
Janitorial	6.3	92.6	1.0	100.0
Quality of Repair	7.3	87.8	4.9	100.0
Speed of Major Repair	4.0	93.2	2.9	100.0
Speed of Minor Repair	4.0	90.1	5.9	100.0
Overall Maintenance	6.4	91.3	2.2	100.0

Note 1: Percentages based on weighted tenant sample, excluding missing data. Raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

Note 2: Categories may not equal 100% due to rounding.

Table 3.6

Landlord Perceptions of Changes in Maintenance in Last Year

	Better	Same	Worse	Other	Total
Janitorial	23.0	68.6	4.7	3.7	100.0
Quality of Repair	23.7	69.1	3.5	3.6	100.0
Speed: Major Repair	19.8	67.1	7.5	5.6	100.0
Speed: Minor Repair	14.9	69.4	10.8	5.0	100.0
Inspections of roof, boiler and drainage	11.3	78.2	5.1	5.4	100.0

Note 1: Other includes: question not asked, no response, not in a position to know or repairs not required.

Note 2: Categories may not equal 100% due to rounding.

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

As can be seen, a sizable majority of landlords indicated the same level of maintenance. Among those indicating a change, there is a greater tendency to indicate improvement than deterioration.

In comparing tenant with landlord responses, it would appear that the responses of individual tenants and landlords are roughly similar. When aggregated within each building, the tenant information shows a greater tendency to show no change. Landlords are somewhat more prone than tenants to say there has been improvement.

The landlord results on the five-year questions are very similar to their one-year responses. Again, most landlords indicate no change, and somewhat more indicate improvement than deterioration, (see Table 3.7).

Table 3.7

Landlord Perceptions,
Changes in Maintenance Over The Last 5 Years

	Better	Same	Worse	Total
Janitorial	28.2	65.8	5.9	100.0
Quality of Repair	27.0	52.8	20.1	100.0
Inspections	18.4	73.5	8.5	100.0

Note 1: Data after eliminating those who don't know.

Note 2: Categories may not equal 100% due to rounding

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

In all, the evidence on changes in maintenance does not support the view that conditions have become noticeably worse. While landlords might be expected to have some bias toward indicating improvements, the tenant responses seem to confirm that Toronto is not experiencing the type of deterioration that has been associated with maintenance in a number of other jurisdictions.

Problem Buildings

In this section differences in maintenance levels will be related to various building characteristics.

In Table 3.8, the overall index of building maintenance is compared with buildings of different ages. It can be seen that over 90 per cent of new

Table 3.8

Grand Index by Building Age

Index Score	Year of Building Completion		
	Until 1960	1961 - 1975	1976 - 1980
	(Per Cent of Buildings)		
25 - 49.9	3.0	0.0	0.0
50 - 74.9	1.9	12.2	1.5
75 - 99.9	54.5	36.8	4.6
100 - 124.9	36.3	42.2	63.1
125 - 149.9	4.3	8.8	30.8
	100.0	100.0	100.0

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

buildings have a score of over 100 indicating above average levels of maintenance. This per cent over 100 drops to about 50 per cent for buildings constructed in the 1961 to 1975 period and to 40 per cent for buildings from 1960 or earlier. Thus, there would seem to be some tendency for maintenance quality to be lower for older buildings. However, it is also apparent that many older buildings still have a high quality of maintenance.

In Table 3.9, comparisons are made by building size. The most noticeable feature is that the small buildings seem to have a greater tendency to be in the 75 to 99.9 point range on the overall index, and experience fewer cases above and below this range. Apart from this, there does not appear to be any strong size related variation in building maintenance.

In Table 3.10, overall scores are compared for buildings with average rents above and below $300. More expensive buildings are more likely to have above average maintenance levels, although it is still true that almost 40 per cent of them have below average maintenance while about one-third of the lower priced buildings are above average.

Table 3.9

Grand Index by Building Size

Index Score	Number of Units in Building		
	20 - 49	50 - 199	200+
	(Per Cent of Building)		
25 - 49.9	1.5	2.1	0.0
50 - 74.9	2.0	9.4	8.7
75 - 99.9	58.0	39.4	34.9
100 - 124.9	34.8	39.5	49.3
125 - 149.9	3.7	9.6	7.0
	100.0	100.0	100.0

Note: Categories may not be equal 100% due to rounding

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

Table 3.10

Grand Index by Building's Rent

Index Score	Responding Tenants' Average Rent	
	$1 - $300	$301 and over
	(Per Cent of Buildings)	
25 - 49.9	2.7	0.0
50 - 74.9	7.9	10.7
75 - 99.9	54.5	27.3
100 - 124.9	33.5	49.1
125 - 149.9	1.4	12.9
	100.0	100.0

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

In Table 3.11, a fairly strong relationship is indicated between building maintenance level and the per cent of tenants reporting that someone was available 24 hours a day to attend to maintenance problems. This seems to indicate that 24 hour availability is a good indicator of maintenance effort.

In Table 3.12, there is some evidence that landlords who plan to sell the building are much more likely to have low levels of maintenance. Caution should be exercised here, however, given that the number of actual respondents who plan to sell was 26. It is not entirely clear what this indicates in that several possible explanations exist:

- both poor maintenance and desire to sell may be related to some other factor such as low profitability;
- once a decision to sell is made landlords lose interest in maintaining the building;
- after a building deteriorates, landlords want to get rid of it.

Table 3.11

Grand Index by Tenant's Indication of 24 Hour Availability of Superintendent

Index Score	Per Cent of Tenants in Building Indicating Availability		
	0 - 49.9	50 - 74.9	75 - 100
	(Per Cent of Buildings)		
Below 100	88.4	59.2	37.9
100 and Over	11.6	40.8	62.1
	100.0	100.0	100.0

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

A good deal more information would be required to sort out the direction of the causation in such cases.

Table 3.12

Grand Index by Landlord Intention to Sell

Index Score	Plan to Sell	No Plan to Sell
	(Per Cent of Buildings)	
Up to 99.9	88.3	51.0
100 and Over	11.7	49.0
	100.0	100.0

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing

Obstacles to Maintenance

As part of the landlord questionnaire the respondent was asked:

> Are there any obstacles which prevent you from maintaining this building at the quality level you would like to obtain?

Table 3.13 records the response to the question. The items with asterisks were included in the question as examples of possible problems.

The results from the question indicated that the most commonly mentioned obstacle was lack of funds (49.3%), with rent review being the second most mentioned problem (23.6%). In that a number of landlords mentioned both of these items, the total mentioning one or both of them (58.3%) is less than the sum of the two figures in Table 3.13. In that 31.9 per cent mentioned no problems, it follows that only 9.8 per cent of landlords mentioned problems without mentioning either rent review or lack of funds.

Table 3.13

Landlords' Perception of Obstacles to Maintenance

Obstacle	Per Cent Mentioning
Rent Review	23.6
Lack of Funds*	49.3
Quality of Materials*	2.6
Age of Building or Equipment*	13.2
Personnel*	2.8
Vandalism	1.8
Bad Tenants	4.8
Owner Policy	3.1
No Obstacle	31.9

*Note: Some landlords mentioned two obstacles

Source: Based on raw data from Social Policy Research Associates weighted by Ministry of Municipal Affairs and Housing.

CHAPTER 4 — Rate Of Return

From a landlord's viewpoint, one of the most important of all considerations is the adequacy of the rate of return on investment in residential rental buildings. Financial viability of buildings should also be of interest to tenants in that a failure to maintain an acceptable rate of return inevitably leads to a diminished supply and quality of private rental buildings.

It should be acknowledged, however, that there is not universal acceptance of the concept of the earning of a financial return by landlords. Some reject the concept that rental housing is an appropriate source of investment profits. Consideration of this type of objection will be dealt with in Chapter 9. This Chapter accepts the validity of a rate of return and will analyze it from the perspective of standard investment analysis.

Each of the following sections deals with one component of study. The section on investment theory will establish the conceptual base for the analysis of rate of return in rental real estate. The section on methodology will outline the approach used in this study. The section on survey findings will document the results of our investigation of landlord financial statements. The section on alternative investments will contrast our survey findings with the returns available on other investments. The section on management behaviour will describe the management strategies adopted by landlords. And the sections on market differences and the maintenance issue will deal with the other issues arising from the study.

Investment Theory

The two motivations of investors, that are at the basis of all financial analysis, are the desire to earn an investment return and the desire to reduce or avoid risk and uncertainty. The higher the return and the lower the uncertainty, the greater will be the willingness of investors to put their money into rental buildings.

Investment return can be earned by landlords in a number of forms: cash flow from operations; capital gains on sale; tax benefits and the payment of mortgage amortization. Each of these will be discussed in this section as they relate to important aspects of the investment analysis of landlords' decisions.

The section will also deal with a number of aspects of risk faced by landlords. The relevant concepts of risk will be introduced as required.

The subsections that follow deal with a variety of issues:

(a) use of static vs. dynamic measures of return;

(b) use of return on capital vs. return on equity;

(c) individual buildings and large portfolios;

(d) comparison with investment alternatives;

(e) the role of capital gains;

(f) the role of tax benefits;

(g) the role of amortization payments;

(h) concluding comment.

(a) static vs. dynamic measures

Basic to any discussion of rate of return is the selection of an appropriate measure. In this and the following sub-sections the desirable characteristics of such a measure will be discussed.

Because the level of profits in any industry will typically change over time, it is important to have measures of financial return that deal with the time dimension. In this respect, it is possible to distinguish between static and dynamic measures of return.

Static measures of return measure the financial position in each year, but do not attempt to produce a single summary measure for the state of return over time. The two most commonly used measures are the net operating income rate and the cash-on-cash yield. Net operating income is equal to total revenues from operations minus total operating costs. The net operating income rate is equal to net operating income as a per cent of the total initial capital invested, with capital invested including both debt and equity. The cash flow is equal to net operating income minus debt service and the cash-on-cash yield is equal to cash flow as a per cent of initial equity invested.

Static measures of financial return are of value in gauging both the current profitability of the building and in observing trend in rate of return over time. Buildings with a negative or very low cash flow will not be regarded as viable investments unless the condition can be reversed. Buildings with a low net operating income, but positive cash flow, may be in difficulty if debt service charges are increased because of refinancing. Historically, the typical trend in the rental apartment industry for both net operating income and cash flow has been one of an increase in return over time. Generally, buildings start off with a low or even negative cash flow in their initial years of operation and they experience an increase in return over time. The negative cash flow in the initial years can be carried by the positive cash flow from older buildings. The viability of the entire operation depends on the pattern of increasing return. A major question in the study of rate of return is the impact during rent review on this pattern of investment returns and the consequent impact on management behaviour.

Although the static measures of return are of great value, they fail to provide a full picture of financial position for two reasons.[1] First, they do not provide a fully adequate measure of the total pattern of return over time. Second, it is difficult to incorporate capital gains into the measures. Both of these problems are addressed by dynamic measures of return.

The inadequacy of static meansures of return is that a dollar earned in 1971 is treated as equal in value to one earned in 1981. This is not true since inflation reduces the value of a 1981 dollar compared to a dollar earned earlier. Also, a dollar earned in 1971 could have earned additional income through re-investment. Both inflation and investment accumulation factors can be reflected in an interest rate factor. Thus 1971 profits can be converted into their 1981 equivalent by multiplying the 1971 value by this rate of return factor. Alternatively, 1981 profits can be converted into their 1971 equivalent by dividing by the same int rest rate factor. The latter process is referred to as the discounting and the resulting 1971 value is referred to as the discounted present value in 1971.

The dynamic measure of return over time used in this study is the internal rate of return. The internal rate of return can be defined as the interest rate which equates the initial year investment cost with the discounted present value of the profits expected in all future years.[2] If this rate is higher or equal to that available on other investments, the investment is a good one. If lower, it is a bad one. In judging the rate of return in rental apartments, one can look backward to see if the building has been a good investment in the past by calculating the internal rate of return as of either date of purchase or any other date chosen (e.g., 1971). One may also look into the future and estimate the internal rate of return as of the present point in time based on expectations regarding revenues and expenses.[3]

As with the static measures, dynamic measures exist for both return on capital (both debt and equity) and return on equity. Both can be calculated using the internal rate of return method.

[1]More information on the discussion that follows can be found in M. Bromwich The Economics of Capital Budgeting (Middlesex: Penguin, 1976), chapters 4 and 5.

[2]The manner in which capital gains are included will be treated in sub-section (e).

[3]The major alternative to use of the internal rate of return is the present value criterion. Economists prefer present value because it overcomes difficulties arising from alternating positive and negative income streams over time. It does, however, have a major practical difficulty in that it requires specification of a discount rate for its use. Major disagreements exist over the selection of the appropriate rate for use in present value calculations.

In this study both static and dynamic measures are used in financial analysis. The further choice between returns on equity and capital will be discusssed in the next sub-section.

(b) capital vs. equity returns

As discussed in the last sub-section, static and dynamic measures are available on both a return on capital and on equity basis. The question may be raised as to which is most appropriate for investment analysis.The answer to this question is that both are of some importance and that the real question concerns the purpose for which each measure is appropriate. In order to arrive at the answer to this further question, it will be necessary to understand some of the basic concepts of the theory of the cost of capital and the capital structure of firms.[4]

As pointed out at the beginning of this section on investment theory, investors seek financial return and wish to avoid risk of lower returns. Investment risk is the potential for variation of operating results from their average expected value. That is, landlords and other investors will have a view as to what future trends in revenues and operating expenses will be and hence will have a view as to what the flow of net operating income will be. But the future is not certain, so that either revenues or costs or both may well vary from that which is expected. Thus, the return on total capital invested, both debt and equity, will be known only within a range of estimates and the size of this uncertainty will be of importance to investors. In general, the higher the uncertainty, the greater the average expected return will have to be in order to induce sufficient investment. It follows that government policies that increase the uncertainty of return can be expected to lower the volume of investment.

The investment risk in any business is independent of the financial structure of the firm. But there is also financial risk that is related to the capital structure. The use of debt financing raises the question of how risk is shared between debt and equity holders and also raises questions of how this risk will vary as the mix of debt and equity changes.

Debt bears a smaller portion of risk for two reasons. First, payment of interest is a contractual obligation which must be met on a continuing and regular basis. Equity's share of the total return to capital then is a residual after payments to debt holders and, therefore, is subject to greater variation. Second, in the event of financial failure, debt holders have first priority of claim. In the real estate sector, typically, the debt holder will hold a mortgage which means that the building itself serves as security against default. In addition, the existence of mortgage insurance further reduces the risk borne by lenders.

[4]A more extended discussion of the concepts that follow can be found in M. Bromwich, chapters 6 to 8.

The difference in risk between debt and equity holders is illustrated in Table 4.1. Clearly, greater uncertainty attaches to the return to landlords.

Given the greater risk borne by equity holders, one would expect that the return on equity would have to be higher on average than the return on debt. This higher payment will compensate owners for bearing a higher portion of risk. Thus, it is not appropriate to compare return on equity to return on debt without allowing for this additional risk premium.

The amount of risk borne by the landlord will not only be higher than that for the lender, but will also vary according to the proportion of debt in total capital. The debt to capital value ratio is taken as a measure of financial leverage. The impact of financial leverage on risk can be seen in Table 4.2. In this table, the net operating income rate varies from 10% to 20% while the debt to value ratio varies from 10% to 90%. It should be apparent that the per cent return to equity varies a great deal more at a 90% debt to value ratio (between -35% and + 65%) than at a 10% debt to equity ratio (between +9.4% and +20.6%).

Another way of looking at the results in Table 4.2 is that the 20.6% return to a landlord with a 10% debt-to-equity ratio is equivalent to the 65% return with 90% debt. The difference in rate of return is merely a reflection of the higher risk involved, that is the higher probability of low or negative rates of return. Hence, in comparing rates of return among landlords, account must be taken of the risk they bear as a result of leverage. In addition, when comparing the rate of return in real estate with that in other industries, one should also take leverage into account. For these reasons the return on total capital is a better basis of comparison than the return on equity, in that the former measure is not distorted by the degree of leverage.

While return on total capital is the better comparative basis for investment, the return to equity is also of value in individual building analysis. If the return on equity is greater than the return on capital, the landlord has 'positive leverage' and debt is being used advantageously. If the return on equity is below that on capital, the landlord has negative leverage and this decreases his return.

In some cases the return on equity will be negative and this may well indicate serious financial difficulties. In addition to concern with the current cash flow position, one may be concerned with the potential change in cash flow on refinancing. The cash flow subsequent to mortgage negotiation will, in turn, depend on whether market conditions enable financing costs to be passed on to tenants.

Table 4.1

Difference in Risk between Debt and Equity

Assumptions:

Total Capital	$100,000
Mortgage Debt	50,000
Landlord Equity	$ 50,000
Mortgage Terms	15% Interest Only Mortgage

Net Operating Income	Return to Capital	Debt Payment*	Return to Debt	Cash Flow to Equity	Return to Equity
-5,000	-5%	7,500	15%	-12,500	-25%
0	0%	7,500	15%	-7,500	-15%
5,000	+5%	7,500	15%	-2,500	-5%
10,000	+10%	7,500	15%	+2,500	+5%
15,000	+15%	7,500	15%	+7,500	+15%
20,000	+20%	7,500	15%	+12,500	+25%
25,000	+25%	7,500	15%	+17,500	+35%

*Assumes no default, if mortgage insured lender will get money back on default.

Table 4.2

Impact on Financial Leverage on Return on Equity

Assumptions:
Total Capital $100,000
Mortgage Terms 15% Interest only Mortgage

		Debt to Value Ratio		
		10%	50%	90%
A.	Net Operating Income	$10,000	$10,000	$10,000
	Debt Payment	1,500	7,500	13,500
	Cash Flow to Equity	8,500	2,500	-3,500
	Equity	90,000	50,000	10,000
	Per Cent Return to Equity	9.4%	5.0%	-35%
B.	Net Operating Income	15,000	15,000	15,000
	Debt Payment	1,500	7,500	13,500
	Cash Flow to Equity	13,500	7,500	1,500
	Equity	90,000	50,000	10,000
	Per Cent Return to Equity	15.0%	15.0%	15.0%
C.	Net Operating Income	20,000	20,000	20,000
	Debt Payment	1,500	7,500	13,500
	Cash Flow to Equity	18,500	12,500	6,500
	Equity	90,000	50,000	10,000
	Per Cent Return to Equity	20.6%	25.0%	65.0%

(c) building portfolios

Mention has already been made of the pattern that was typical to the industry whereby negative cash flow on a building during the first few years could be carried by positive cash flow from older buildings. It seems useful to also mention several other distinctions between small landlords with one or two buildings and those with large portfolios.

In particular, mention should be made of the degree to which risk differs between those with few and those with many buildings.[5] In general, the degree of risk borne is greater for those who have a large portion of their wealth in a few buildings. This is due to the advantage those with more buildings have from pooling the risks involved. The advice that one should pool risk by diversifying one's investments is a fancy way of saying that one should not put all one's eggs in the same basket. The potential for loss is much greater with only one investment. With more investments, the losses on some investments can be balanced by the gains on others and the overall rate of return will tend toward an intermediate average. Hence, large landlords owning many buildings or landlords with investments other than rental apartments are more diversified than more specialized landlords.

Diversification, however, will only be advantageous where there is a degree of independence of risk among the various investments. If investments share the same risks, there may be limited value from diversification. For example, a wheat farmer with a section of land will gain no great advantage in the form of reducing risk by adding another section of land to be used in wheat production immediately adjacent to and of similiar characteristics to the first section. This is because the major factors affecting yield, (e.g., rain, drought, frost, etc.) are likely to be the same for both sections. In the rental housing context, owning several buildings in an Ontario city will reduce the total risk associated with some items (e.g., major expenses associated with repair of major systems) but not for others (e.g., impact of change in municipal property tax mill rate).

In the case of rent review, the risk associated with major changes in policy cannot benefit from pooling of risk among buildings in the Province. Changing the guideline for rate of rent increase, for example, will benefit (or hurt) all controlled buildings in the same direction. The way landlords can protect themselves from the risk associated with policy change is to increase the proportion of their assets held in other jurisdictions or in non-rental housing assets. Thus, a decrease in investment in Ontario rental housing might reflect risk factors as well as any impact of rent review on the average rate of return.

[5]Again, one may wish to consult M. Bromwich, chapters 14 and 15.

(d) investment alternatives

The availability of investment alternatives has a major bearing on the impact of rent review on rate of return. A 10 per cent return on capital in rental housing is a poor return if other investment returns are 20 per cent, but a good return if other investments are yielding 5 per cent.

In making an evaluation, one must be careful to take relative risk factors into account. Thus, a risky investment or a highly leveraged asset will require a higher rate of return.

In addition, one must pay careful regard to the pattern of investment return over time. Debt instruments often have a fixed return over time while equity returns usually show an upward trend. Clearly a comparable basis must be taken as a starting point for analysis.

(e) capital gains

As indicated above, capital gains can readily be incorporated into dynamic measures of internal rate of return. The market price of the building at the time of sale is simply included as a cash flow in the year of sale and this amount is discounted back to the initial year and included in the calculation of the internal rate of return.

With static measures of rate of return, capital gains can not be directly integrated. However, converting the total appreciation in value to an average annual increase will provide an indication of the importance of capital gains.

The major issue surrounding capital gains involves the relationship between capital gains and landlord profits. The question that arises is whether capital gains can be made in the absence of profits. This question is essentially the same as that of corporate stock that is not paying a dividend. This issue has been adequately discussed by J. Van Horne:

> The above discussion does not imply that the company that pays no dividend has no value. Investors in such stocks purchase them with the expectation of being able to sell them in the future at a price greater than what they paid for them. Instead of dividend income plus terminal value, they rely only upon terminal value. However, the terminal value will depend upon the expectations of other investors at the end of the holding period. The ultimate expectation is that the company someday will pay dividends, whether regular or liquidating, and that investors will receive a cash return. Because cash dividends are all that stockholders as a whole receive from their investment, they are the foundation for valuation. These dividends, of course, are closely tied to the prospective earnings performance of the company.[6]

[6]James C. VanHorne, Function and Analysis of Capital Market Rates (Englewood Cliffs, New Jersey: Prentice Hall, Foundations of Finance Series, 1970) p.154.

Clearly then, the instance of a rental building which is never expected to earn a profit not only will not produce capital gains, it would mean the building was worthless as an investment. It follows that provision for profits is necessary in order to make rental buildings financially viable.

Of course, it still might be possible that certain buildings would retain value because of the potential for conversion of the building or site to another use. While this might still provide a capital gain to the landlord in these cases, such a result is hardly consistent with the continued preservation of an adequate supply of rental housing.

(f) tax benefits

Shelter for tenants may also be shelter for taxes. For this reason the potential tax situation of landlords should be of concern in judging rate of return.

The tax measure of greatest importance is the treatment of capital cost allowance. The capital cost allowance is the allowance in income tax legislation to cover depreciation. It is a non-cash flow expense that reduces the firm's taxable income and in some cases, to be discussed below, also can be used in offsetting other taxable income of the taxpayer.

The rationale behind capital cost allowances is that the landlord (or other investor) should be allowed to conserve the value of his investment in a depreciating asset. That is, if a building has a 20-year economic life, the investor should be able to recover the initial cost of that investment free of tax over that period so that the investor would be in a position to reinvest the initial capital in a new building at the end of the period. Thus, it is a measure that aims at the preservation of the nation's capital stock.

If the capital cost allowance were equal to true economic depreciation, this measure would not confer any net advantage to the investor other than the conservation of capital funds. However, the capital cost allowance in most cases exceeds the true economic depreciation with the result that a tax benefit is created.

From an investor's viewpoint, tax sheltering becomes an inducement to invest:

> Essentially, all that is involved in tax sheltering is the utilization of permissible deductions under the relevant income tax legislation at the earliest point in time and of the maximum quantum to offset taxable income which would otherwise attract immediate tax. At the very least, the tax liability is deferred until later years when the taxpayer's marginal tax rate may be less and, even better, the taxpayer may realize an investment or other return on the amount of tax deferred. Also, if possible, the quality of taxable income might be altered so that ordinary income is

converted to capital gain, or income not qualifying for sheltering through forward averaging is converted to income which does so qualify.[7]

Thus, tax sheltering confers a net economic advantage to the firm. In addition, real estate companies, insurance companies and individuals investing in a building qualifying for tax advantages of Multiple Unit Residential Buildings (M.U.R.B.) have the additional advantage of being able to use their losses on buildings as a means of reducing other taxable income.

It might be noted that while accelerated depreciation creates a tax benefit for landlords, there is an additional feature of the tax system treatment of depreciation that works in the opposite direction. Depreciation is calculated on the original cost of the building, not the cost required to replace it. Hence, with inflation, accumulation of the original cost of the building would not allow for its replacement with an equivalent structure. That is, it would not be sufficient to conserve the capital of the landlord.[8] Accelerated depreciation, then, can be viewed as an offset to the effects of inflation. The net impact of these two forces is uncertain and would require a major study to determine.[9]

(g) amortization payments

Under rent review, amortization payments as well as interest have been allowed as an expense for cost pass-through purposes. This fact has given rise to two issues. One concerns the fact that amortization payments build up the equity of the landlord and the claim that the tenants buy the building for the landlord. The other relates to the size of the rate of return to the landlord provided by the equity build up and the claim that this return alone amply rewards investment so that no other return is necessary.

Before discussing these issues, it may be useful to recall the reason that mortgage payments were chosen as a pass-through cost rather than depreciation allowances. Had capital consumption allowances been chosen, the higher amounts allowed in initial years and the declining

[7]G.D.F. Skerrett, "Tax Sheltering and Syndication of Multiple-Unit Residential Buildings," (Canadian Tax Foundation: Corporate Management Tax Conference, 1977) p.126.

[8]For a discussion of the impact of inflation on capital investment see Report of the Ontario Committee on Inflation Accounting (1977).

[9]For the period to 1974 see G.P. Jenkins Inflation: Its Financial Impact on Business in Canada (Economic Council in Canada, 1977) chapter 2. An American source is H.J. Aaron, ed., Inflation and the Income Tax (Washington, D.C.: Brookings Institution, 1976) especially chapters 2 and 10.

amount allowed over time would have effectively decontrolled any recently built or acquired buildings (where the allowances were much above mortgage payments) and have caused potentially serious cash flow losses on older buildings (where allowances were below the cash flow required for mortgage payments). It was decided that the results from using capital cost allowances would have been at odds with the intent of the legislation, so that the cash-flow concept of capital expenditures was adopted.

There is an argument that principal payments should not be allowed because, in effect, by allowing such payments, tenants would be buying the building for the landlord. It is true that tenants would be providing the funds for the landlord's purchase of the building — but there is nothing exceptional in this. It is the way the free enterprise system is supposed to work. To use an analogy, if one were to take over a hardware business by paying $50,000 down and borrowing $200,000 from a banker — how, then, would the merchant normally obtain the $200,000 to pay off the bank loan? The answer is: by selling hardware. Customers in buying saws, hammers and power drills would be providing the merchant with profits that would then be used to pay off the loan, thereby increasing the merchant's equity in the hardware business. Customers would be providing the funds to buy the business. The same is true in the rental sector. Tenants rent payments are used by landlords to meet the principal repayments on the building. To deny this source of funds to landlords would be equivalent to requiring the hardware store owner to obtain the funds to repay his bank loan by taking a second job and using only these funds to acquire the remainder of the equity in his business. This would not be regarded as being fair and, further, if such a rule were to be enforced it would serve as a strong negative deterrent to investment.

The size of this return has also been at issue. Dale Martin has argued:

> Why is there a 22.7 per cent minimum real profit even if a landlord is just 'breaking even' at Rent Review? Tenants' rents go to pay for the cost of operating the building and making mortgage payments. Now, assume the landlord bought a building at a price of $100,000. He put down 15 per cent of that price of $15,000 of his own money and mortgaged the remaining $85,000 with a traditional 25-year mortgage. On the mortgage the landlord wil get back $85,000 as equity in the building over the 25 years (assuming the building does not go up in value). This represents $3,400 return to him each year or 22.7 per cent on his original $15,000 investment.[10]

[10]Dale Martin, "Rent Review and the Supply of Rental Accommodation," (Toronto: Federation of Metro Tenants' Associations, 1978) p.3 (mimeographed).

The one problem with this analysis is that it ignores the time value of money as outlined in sub-section (a) above. Given the standard blended payment mortgage, the bulk of the amortization payment is made during the final few years of the mortgage. Assuming a 20 per cent mortgage, 62 per cent of the loan in the example would be paid off during the final 5 years of the mortgage. The present value today of each dollar earned 20 years from now at a 20 per cent interest discount is only 2.6 cents. At 25 years this drops to 1.0 cent. Clearly, the amortization earnings of landlords will make little difference in the evaluation of current investment decisions given other factors and uncertainties. Hence, other profit inducements will be required in order to encourage rental investment.

(h) concluding comment

This section on investment theory has examined various aspects of rental housing investment on the same basis as any other investment. The treatment here has been quite standard, as can be verified by reference to the texts referred to in the analysis. Despite the orthodox nature of this discussion, some will object to it.

One objection will be that not all landlords treat their investment in such a rigorous analytical framework. This is certainly true for smaller landlords. Nevertheless, the theory serves as a reasonable approximation in the sense that any substantial departure from the investment results outlined can be expected to be reflected in negative attitudes and behaviour on the part of landlords. While some landlords may over - or under-react to changes in the investment environment, standard theory forms a good basis for indicating what landlords in general will do.

A second objection would be that the results of investment decisions are not fair in the sense that landlords should not treat rental housing as an investment and should not earn profits of the sort indicated here. Again, as at the start of the Chapter, it is noted that this Chapter deals only with what investors can be expected to do and not with questions of what they should do. These questions of values, which are taken up in Chapter 9, are not to be confused with the technical investment analysis of this Chapter.

Methodology

The nature of the information relevant for a study of rate of return is such that it can only be obtained from landlords or their agents. To collect financial information from landlords requires their co-operation. In order to maximize co-operation, a consultant (Price Waterhouse) was retained.[11]

[11]Note that Price Waterhouse was responsible for gathering and verifying the data, the Ministry of Municipal Affairs and Housing bears full responsibility for the analysis of it.

The information on rental buildings used in this study falls into three categories: soft, hard and derived. Soft information refers to the landlord's answers recorded to open ended questions posed by the representative from Price Waterhouse.

Hard information relates to landlord financial data collected by Price Waterhouse. In all completed questionnaires, this included annual information on revenues, operating costs, net operating income, debt service and cash flow before taxes. It also included the equity and debt outstanding at the beginning of the observation period (1971 or acquisition). Finally, in most cases more detailed information on components of revenues and cost was obtained.

Derived information relates to information that was estimated, in part, by the Ministry. Capital gains could not be observed directly in the terminal year (1980) in most cases — i.e., few buildings were sold in that year. Landlord estimates of value were not always realistic. Similiar problems existed for buildings with holding periods going back further than our deemed initial year for data collection (1971). For these reasons, where actual data did not exist estimates were made based on:

- Ministry of Revenue gross income multipliers (value as a multiple of gross income derived from assessment experience and knowledge of sales in area);
- Selling prices obtained from TEELA Market Surveys Ltd;
- owner's estimate;
- special factors (e.g., location, transportation improvements, building conditions, status as MURB investment).

Another derived item was the cash flow after tax. Because this would have required disclosure of the landlord's personal finances, it was not thought likely that such information could have been obtained. Instead, two investor types were assumed: one who had other income against which tax losses could be written off and the other who could not. Calculations were made for each investor type.

The most important issue in the choice of methodology concerns the choice between a representative sample and a case study approach.

The pre-test survey indicated that the response rate would probably not be above 50 per cent, which is well below the minimum of 70 per cent used by the Ministry as a level required for generalizing results to the total population. Had a full representative sample been conducted with the same 50 per cent response, the results would have been open to the

challenge that the non-respondents were possibly different than those who co-operated and that the true picture for all eligible respondents might be quite different from those who answered. Hence, the accuracy of a representative sample would be open to challenge and for this reason it was abandoned.

Although we are not in a position to generalize results to the entire population, the use of a case study approach, rather than a representative sample, has permitted a much more detailed and flexible approach to exploring the actual processes at work in individual cases. In particular, it has enabled us to describe the management behaviour patterns of landlords. Thus, this study provides greater depth of perception of landlord's behavioural reaction to their profit experience and the implications of this behaviour for tenants.

In proceeding with a case study a number of decisions were made. First, the source used for most building selection was the Canada Mortgage and Housing Corporation Apartment Universe. Selections from this list were made so as to include a mix of various sizes of buildings,[12] various ages of building and a range of locations.

Buildings were selected from Toronto and London in order to examine the differences due to the much tighter occupancy situation in Toronto versus the higher vacancy conditions in London. The method of selecting from the C.M.H.C. Apartment Universe was not keyed to finding specific case types. As a result, two case types were not picked up with sufficient frequency and Price Waterhouse attempted to select buildings of these two types from their own clients.[13] The only other means of access occurred during the pre-test phase when several landlords associated with the Multiple Dwelling Standards Association volunteered to provide information. Their co-operation was valuable in this regard. In all cases, the building was selected by Price Waterhouse rather than the landlord. Hence, there was no opportunity for the landlord to substitute a building with a different financial history than the one pre-selected.

Description of Total Sample

Before considering the differing management behaviours in the sample, it is useful to present a summary of the leading rate of return measures for the 68 buildings surveyed. Because it proved impossible to contact previous owners and obtain financial records from them, the data presented here relates to current owners only with the exception of a small number of cases involving recent sale. It should also be noted that the data here, while descriptive of the sample, cannot be taken as fully representative of the total population of rental buildings.

[12]A minimum size of 20 units was set in view of potential data access and quality problems for very small landlords.

[13]Two case types, which will be explained later, were the Unscathed and the Forced-Out.

In Table 4.3, the response to the survey is presented. The response rate can be computed in a variety of ways. If one takes valid completed interviews (68) as a per cent of total qualified buildings approached (190), the rate of response is 35.8 per cent, with 34.4 per cent in Toronto and 46.4 per cent in London. Thus, respondents were a minority of those approached. It is not possible to make any strong inferences from either soft information or non-respondent questionnaires, about the profitability experience of those who did not provide data.

In Table 4.4 the static return to total capital, the net operating income rate, is presented.[14] From this Table it can be seen that in 1980 almost two-thirds of respondent buildings had a net operating income rate below 10 per cent, and all buildings save one were below 15 per cent. In 1975, all Toronto respondent buildings except one were below a 10 per cent net operating income rate, while in London 3 of the 8 buildings were above 10 per cent. Almost all Toronto buildings for which data was available showed an increase in net operating income between 1975 and 1980, although one would be careful to note that this does not necessarily mean such income kept up with either inflation or other investment returns. In London 4 out of 8 buildings actually had lower net operating income in 1980 than five years earlier.

In Table 4.5 the cash-on-cash yield on initial equity[15] is presented for respondent buildings. As explained in the section "Investment Theory", the existence of leverage results in a greater spread of returns in Table 4.5 compared to the previous table. Indeed, almost one-third of the buildings (21 of 66) actually experienced a negative return to equity in 1980, while at the other end of the spectrum, 7 of the 66 buildings had positive returns of 20 per cent or more. The median increase was below 10 per cent. It is also apparent that London landlords in general fared worse than their Toronto counterparts in 1980.

Again, comparisons with 1975 show improvements in almost all Toronto cases and a split in London cases. Actual cash flow losses in 1975 were much rarer. It was also true that returns to equity above 10 per cent were experienced in only a few Toronto cases in 1975.

[14]Note: In the tables that follow 2 of the 68 buildings were excluded because of abnormal debt to value ratios. These buildings will be discussed separately below.

[15]Initial equity is taken as the equity in 1971 or on purchase if after 1971 in most cases.

Table 4.3

Survey Response

Description	Toronto Phase I	Toronto Phase II	Total Toronto	Total London	Total Toronto and London
Completed Interview	14[1]	42	56[1]	13	69[1]
Soft Information Only[2]	N.A.[3]	14	14	2	16
Non-Respondent Questionnaire	N.A.[3]	9	9	1	10
In Process[4]	2	18	20	0	20
Not Qualified[5]	0	12	12	0	12
Out-Right Refusal	1	13	14	1	15
Unable to Contact Owner, No Call Back, etc.	21	28	49	11	60
Total Buildings Approached	38	136	174	28	202

1. One completed interviewed from Phase I was omitted from survey results because of a low degree of confidence in the data.
2. Soft information: owner provided responses to questions but no financial data.
3. Categories not applicable to Phase I methodology.
4. Due to nature of survey, an ongoing supply of respondents were needed.
5. Non-profit buildings contacted in error.

Source: Based on data collected by Price Waterhouse

Table 4.4

Net Operating Income Rate

Rate	1980 Toronto	1980 London	1980 Total	1975 Toronto	1975 London	1975 Total
0 - 4.9	3	4	7	2	1	3
5.0 - 9.9	28	4	32	25	4	29
10.0 - 14.9	22	4	26	1	3	4
15.0 - 19.9	0	0	0	0	0	0
20.0 and above	0	1	1	0	0	0
Not Available	-	-	-	25	5	30
Total	53	13	66	53	13	66

Change in Net Operating Income 1975 to 1980	Toronto	London	Total
Increase	26	4	30
Decrease	2	4	6
Not Available	25	5	30
TOTAL	53	13	66

Note: Median NOI rate in 1980 = +9.3%

Source: Based on data collected by Price Waterhouse

Table 4.5

Cash on Cash Yield

Yield	1980 Toronto	1980 London	1980 Total	1975 Toronto	1975 London	1975 Total
-30.0 and Below	1	3	4	0	1	1
-29.9 to -20.0	1	3	4	0	0	0
-19.9 to -10.0	4	1	5	0	0	0
-9.9 to -0.1	7	1	8	4	0	4
0 to 9.9	20	1	21	21	3	24
+10.0 to 19.9	15	2	17	3	4	7
+20.0 to 29.9	4	2	6	0	0	0
+30.0 and Above	1	0	1	0	0	0
Not Available	0	0	0	25	5	30
TOTAL	53	13	66	53	13	66

1975 - 1980	Toronto	London	Total
Increase	26	4	30
Decrease	2	4	6
Not Available	25	5	30

Median Yield 1980: +6.9%

Source: Based on data collected by Price Waterhouse

In addition to the cash flow returns to capital and equity, landlords will also be interested in the rate of appreciation in building values.

The rate of appreciation in Toronto averaged an estimated 3.8 per cent per year for those buildings with 3 or more years of data. In London, the comparable rate of price appreciation was 3.2 per cent on 8 buildings. Including buildings with less than 3 years data, only 14 of 66 buildings had rates of price appreciation estimated at 5 per cent a year or above.

Turning to the dynamic rates of return, Table 4.6 presents the internal rate of return on capital before tax. Some 58 of the 66 landlords experienced a return on capital between 5 and 15 per cent, with slightly over one-half between 10 and 14.9 per cent. After taxes the typical return falls to the 5 to 9.9 per cent range (See Table 4.7). This means that taxes on profits and recapture of excess depreciation on sale more than outweighed the tax deferral benefits from the capital cost allowance for most landlords in the sample. Indeed, the only group of landlords who derived a net tax benefit were those participating in MURB projects.

Turning to the dynamic return on equity, again the distribution of returns is much wider than for the returns to capital because of the existence of leverage. The picture, however, is broadly similar to the other patterns observed. In Table 4.8, the before tax internal rate of return on equity is presented. About half of the sample experienced a return between 10 and 19.9 per cent, with 13 of the 66 landlords at 20 per cent or above, 11 experiencing a negative rate of return and the 11 others earning a return in the 0 to 9.9 per cent range. In all, almost one-third of the sample had a dynamic return on equity below 10 per cent. It should be remembered that this includes not only cash flow, but also price appreciation and amortization flow.

Table 4.6

Internal Rate of Return on
Capital Before Tax

Rate	Toronto	London	Total
0 - 4.9	1	1	2
5.0 - 9.9	17	3	20
10.0 - 14.9	31	7	38
15.0 - 19.9	2	2	4
20.0 - 24.9	1	0	1
25.0 - 29.9	1	0	1
TOTAL	53	13	66

Median Return: 11.0%

Source: Based on data collected by Price Waterhouse

Table 4.7

Internal Rate of Return on Capital
After Tax with Loss Write-Off

Rate	Toronto	London	Total
-4.9 to -0.1	1	0	1
0 to 4.9	14	2	16
5.0 to 9.9	30	7	37
10.0 to 14.9	1	1	2
15.0 to 19.9	2	1	3
20.0 and Above	0	0	0
Not Available	5	2	7
TOTAL	53	13	66

Median Return: +6.6%

Source: Based on data collected by Price Waterhouse

Table 4.8

Internal Rate of Return on Equity, Before Tax

Rate	Toronto	London	Total
-29.0 to -20.0	0	1	1
-19.9 to -10.0	2	1	3
-9.9 to -0.1	5	2	7
0 to 9.9	10	1	11
10.0 to 19.9	26	5	31
20.0 to 29.9	6	2	8
30 and Above	4	1	5
TOTAL	53	13	66

Median Return: +13.9%

Source: Based on data collected by Price Waterhouse

When tax considerations are taken into account, once again the returns are lower than on the pre-tax basis. The results in Table 4.9 show that in the after tax return, the largest group of landlords (26 of 59) earned between 0 to 9.9 per cent, with more falling in the lower half of that range. While 5 buildings earned over 30 per cent, 9 others actually experienced a negative return.

Somewhat surprisingly, the pattern of dynamic rates of return on equity were not greatly different between Toronto and London. If one were to adjust the numbers for London in Table 4.9 by multiplying by 4, one would see about the same number of negative returns (7 Toronto, 8 London), almost the same number between 0 and 9.9 per cent and the same number above 30 per cent (4). More Toronto buildings were between 10 and 19.9 per cent (16 vs. 12), while more London buildings were in the category for which after-tax returns could not be computed (8 vs. 5).[16]

Table 4.9

Internal Rate of Return on Equity After Tax for an Investor Who Can Write-Off Loss

Rate	Toronto	London	Total
-20 and Below	0	1	1
-19.9 to -10.0	0	1	1
-9.9 to -0.1	7	0	7
0 to 9.9	21	5	26
10.0 to 19.9	16	3	19
20.0 to 29.9	0	0	0
30.0 and Above	4	1	5
Not Available	5	2	7
TOTAL	53	13	66

Median Return: +8.7%

Source: Based on data collected by Price Waterhouse

[16]In order to compute after tax returns, one required either the current undepreciated capital cost or the original split in value between land and building. In 7 cases neither of these values was obtainable.

As indicated above, two buildings in the sample were excluded from Tables 4.4 to 4.9 because of abnormal debt to value ratios. In one case the debt was 134.3 per cent of value, in the other 118.8 per cent. In both cases these ratios resulted from the lease of the land on which the buildings were situated. In these cases the landlord was borrowing not only against the value of the building that he owned, but also against the value of the lease on the land. As conventionally measured, the equity of the landlord is negative. The value of his debt exceeds the value of what he owns (the building). This would render any computations of return on equity rather meaningless. Instead, what will be presented here is an adaptation of the basic economic principles to these unconventional cases.

Table 4.10 presents the data used in deriving an estimate of what the returns on these buildings would have been if the land was owned by the landlord. Note that an assumption must be made as to what the debt to value ratio would be under these changed circumstances.

Two ratios have been chosen at the mid to high end of the normal range (80 and 90 per cent debt). Given these assumptions the net operating income rate on both buildings would have been in the range between 6 and 7 per cent and the cash-on-cash yield would be negative with Building #97 in the -2 to -6 per cent range, and Building #151 in the -1 to -3 per cent range. Both buildings, then, would probably be in the lower end of the profitability range if normally financed.

Comparative Rates of Return

The returns experienced by the respondent buildings in the sample can be compared to both their owners' expectations and to the returns available on alternative investments.

As part of the survey, landlords were requested to indicate the rate of return that they considered adequate on their investment. This amount was then compared with the return they actually achieved. For the 59 properties for which comparisons could be made, 34 of them (or 58 per cent) experienced lower returns than their target rate. As will be seen in the discussion on management behaviour, the number falling below their target rate would have been higher if various cost cutting strategies had not been followed. The discussion of implications of these strategies will also be given.

A second approach to judging the return for respondent buildings is to compare the static returns on investment to the rate of inflation. Table 4.11 presents this comparison. The results should be judged with special care in that the results are not only limited to the respondent buildings in our survey but, in addition, relate to a changing composition of buildings due to limitations on the years of back-data obtainable. Nevertheless, the Table shows that the buildings in our sample have done poorly relative to inflation during the past ten years.

Table 4.10

Adjusted Returns on Land Leased Projects

($000)

	Building #97		Building #151	
	Assumption 1	Assumption 2	Assumption 1	Assumption 2
Assumed Debt/Value Ratios	.9	.8	.9	.8
Value of Building and Land per Assumption	$7,042	$7,923	$6,470	$7,279
Actual Debt	6,338	6,338	5,823	5,823
Derived Equity	704	1,585	647	1,456
Net Operating Income 1980	$480	$480	$448	$448
Rate	6.8%	6.1%	6.9%	6.1%
Cash-on-Cash	-$37	-$37	-$20	-$20
Rate	-5.3%	-2.3%	-3.1%	-1.3%

Source: Ministry of Municipal Affairs and Housing estimates computed from data collected by Price Waterhouse

Table 4.11

Real Net Operating Income Rate and Cash-On-Cash Yield

Year	Buildings	Average NOI Rate[1]	Average C/C Yield[2]	Change in Consumer Price Index	Real NOI Rate	Real C/C Yield
1971	15	8.0	5.3	2.9	5.1	2.4
1972	18	7.4	5.1	4.8	2.6	0.3
1973	22	8.0	5.1	7.5	0.5	-2.4
1974	28	8.4	6.3	10.9	-2.5	-4.6
1975	36	8.3	3.1	10.8	-2.5	-7.7
1976	45	8.2	4.7	7.5	1.3	-2.8
1977	48	8.3	3.2	8.0	0.3	-4.8
1978	51	8.7	4.4	9.0	-0.3	-4.6
1979	62	9.3	5.2	9.1	0.2	-3.9
1980	62	9.5	5.6	10.1	-0.6	-4.5

[1]NOI = Net Operating Income

[2]C/C = Cash on Cash

Source: Based on data collected by Price Waterhouse and Statistics Canada Consumer Price Index.

A third comparison involves the after tax returns in other industries. Table 4.12 presents the returns to capital (equivalent to the net operating income after tax) for industry in general and for several individual industries. It can be seen that Real Estate and Construction performed poorly in comparison to Industry in General and, in most years, in comparison to the other selected industries. Also included are the comparable data from the respondents in the survey of rental apartments.

A fourth comparison is with the returns available on various financial investments. Table 4.13 presents the pre-tax results for various investments. It can be seen that the returns on stocks were higher (15.4%) than the median internal rate of return on both capital (11.0%) and equity (13.9%) for respondent buildings. The returns on debt instruments, however, performed more poorly during the 1970's due to a consistent underestimation of inflation by investors during the period.

In general, then, the buildings in our sample did not perform strongly relative to their landlord's targets, the rate of inflation, the returns in other industries or the stock market. They did, however, perform better than investors in the bond market. Even here, it may be noted, things may have changed in that current purchasers of bonds are obtaining rates of interest in the 15 per cent range. It will be seen in the next section how this relative financial performance of the sampled buildings has effected their owners' behaviour.

Management Behaviour

It should not be surprising that there is a relationship between profitability and management behaviour. The case study approach allowed for an exploration of the linkages. In all, seven distinct management strategies were discovered. In the sub-sections that follow they will be referred to as:

- the optimist
- the realist
- the pessimist
- the myopic manager
- the unscathed owner
- the forced-out owner
- the syndicator

Table 4.12

Return on Capital After Tax in Various Industries

Industry	1980	1979	1978	1977	1976	1975	1974	1973	1972	1971	Annual Average 71 - 80
Industry in General	15.8	16.0	12.9	11.6	11.7	11.6	12.5	8.5	7.8	8.9	11.7
Real Estate and Construction	9.7	10.0	8.9	8.3	8.1	7.5	7.7	6.5	5.6	6.8	7.9
Primary Metals	13.4	12.9	11.3	8.1	6.2	7.8	11.3	9.0	6.8	7.7	9.5
Manufacturing	14.3	15.0	10.4	9.8	10.7	11.1	12.9	12.1	6.9	8.1	11.1
Machinery	13.3	19.5	14.3	12.0	14.9	17.3	15.4	16.3	11.9	8.1	14.3
Electrical Equipment	20.7	4.3	10.0	6.8	9.4	14.3	9.9	3.8	9.1	7.5	9.6
Sample Buildings	5.9	5.8	5.6	5.4	5.4	5.3	5.3	5.1	5.0	5.5	5.4

Source: Statistics Canada 61-003 and 61-207 and data collected by Price Waterhouse.

Table 4.13

Returns on Financial Investments Before Tax

Year	T.S.E. 300 Composite Stock Index	Long Term Bonds	90-Day Financial Paper	5-Year Guaranteed Investment Certificates	Interest Rate Savings Deposit
1980	30.13	2.48	13.60	12.31	11.15
1979	44.48	-2.6	11.73	10.33	10.13
1978	29.81	4.10	8.48	9.27	7.87
1977	10.74	9.16	7.78	8.94	6.0
1976	11.02	23.32	9.84	10.09	8.45
1975	18.48	8.05	8.59	9.56	7.45
1974	-25.93	-4.55	10.97	9.70	6.5
1973	0.27	1.99	6.85	8.21	5.43
1972	27.38	8.09	5.09	7.62	4.0
1971	8.01	14.83	4.60	7.72	4.5
Annual Average	15.4	6.5	8.8	9.4	7.1

Source: Bank of Canada Review

As indicated above, out of the 59 owners who responded to the question on profitability targets, 34 of them (58%) were not attaining their profitability objective. In the case types that follow, each grouping has both a typical profitability performance and a typical performance regarding the maintenance of building quality. It is clear that in many cases landlords felt that they were in a position to have one or the other but not both. Table 4.14 outlines the seven case types identified through the survey and indicates the typical performance with respect to profitability and maintenance policy. While all syndicator cases in the sample had below average returns, it was felt that this was not necessarily typical of this case type.[17]

Table 4.14

Profitability and Quality by Case Types

Case Type	Number in Case Type	Typical Profitability vs. Average	Typical Strategy on Quality
Optimist	18	Below	Maintain
Realist	13	Above	Reduce
Pessimist	9	Below	Reduce
Myopic	12	Above	Reduce
Unscathed	6	Above	Maintain
Forced-out	4	Below	Reduce
Syndicator	7	Uncertain	Maintain

In that the results are not based on a representative sampling of landlords, it would be inappropriate to estimate the proportion of landlords faced with the profit-quality trade-off decision. Nevertheless, in that most of the case types in question resulted automatically from the C.M.H.C. list selections with high frequency, it seems safe to conclude that the incidence of landlords reacting to this dilemma is large enough to be of some concern to those interested in future trends in the rental apartment sector.

In turning to the case type analysis it should be remembered that a certain degree of variation exists within each case type. Thus, while the managerial strategy is common to each member of the case type,

[17]One landlord displayed a mixture of two strategies: an unscathed realist who has a substantial rate of return but is augmenting this return through operating cost reductions especially in the area of management overhead expenditures.

differences may exist in those elements not central to the case description. It is, however, quite useful to set out a full range of concerns that are fairly typical within the case type in order to gain a fuller appreciation of the many considerations that must be faced by landlords in making their strategic decisions.

(a) the optimist

The distinguishing features of the optimists' management behaviour is the use of internal financing and the decision to increase the amount of equity by paying down the debt outstanding. This results in a low exposure to the costs of external financing. Indeed, equity may have been increased precisely to avoid the impact of the potential refinancing. The rate of return on invested equity, however, is below that available on other assets and the owner is termed optimistic in the sense that he has the belief things will improve. If this does not prove to be the case, the optimist may switch management behaviours.

Because the owner is an optimist, he is not likely to pursue strategies of large cutbacks in operating expenses or of deferral of capital expenditures. To some extent, however, the owners' expectations are being disappointed by the combination of restricted rents and rising operating costs.[18] Hence, closer control is being kept on increases in operating costs related to non-essential services, maintenance expenditures and management overhead.

The owner is in the business for the longer term, waiting for a turn around in profitability. It is for this reason that the owner has the combination of low return but a strategy of high quality. Future decisions regarding rent review will be important in determining the success of this strategic decision.

(b) the realist

The realist differs in degree from most of the other landlords surveyed. While most landlords are attempting to control their increase in operating expenses, the realist is a great deal firmer in control over cost. Hence, the realist is much more likely to be making either significant cuts in the levels of service provided to tenants or finding areas open to significant productivity improvements. The reward for this is a significant improvement in cash flow position.

While the owner is cutting back on current expenses, there is no desire to cut back on necessary capital repair items, although some repairs may be made on a piecemeal basis. The owner is in the business for the longer haul and does not want to jeopardize the physical integrity of the building.

[18]Note while rent review allows for dollar-for-dollar pass-through of costs, it does not provide for an increasing cash flow over time which is the investment objective for the industry.

(c) the pessimist

The pessimist is an individual caught in a low or negative yield position, who has decided to take equity out of the building in order to invest elsewhere. Such an individual has the expectation that under rent review things will get worse and wishes to get his money out now. This type of owner is willing to sell his building, provided, of course, an acceptable price is offered. It should be noted that while rent review does not permit an owner to increase his rents as a result of increasing the amount of debt outstanding, a new owner could obtain such an increase.

The pessimist may find himself in a low yield position because of a combination of low rent levels when rent review came in and fairly high operating costs. The situation may be aggravated by either a need for large capital expenditures or a required refinancing at a higher rate of interest. In any event, the pessimist believes that his profitability problem is beyond his power to solve and is taking steps to limit his exposure to an unfavourable financial situation.

(d) the myopic manager

The myopic manager is one who is faced with substantial capital expenditures but decides to defer them or to patch and make do. The objective of the manager is to maintain an above average rate of return by his strategy and thus he is not deferring expenditures simply out of financial necessity. This owner is termed myopic in the sense that the delay of expenditures on major capital items may well lead to the need for much more serious expenditures later on, as structural or major system deterioration becomes more serious. Thus, the short-term gain in cash flow may be at the expense of future profits.

While a myopic manager also may be tightening up on current expenditures, this will not be to the same extent as in the case of the realist. The myopic manager is concerned to keep current tenants fairly happy and for this reason is careful not to reduce immediately noticeable items. In many cases, then, tenants may be unaware of the problems that are building up.

Differences exist in the long-term strategy of the myopic manager. Some intend to hold on to the building and are deferring capital expenditures in the hope that the delay will not create serious problems before the time arrives when the profitability of rental investment markedly improves, say, with major changes to rent review. If the outlook should change for the better the deferred expenditures would then be made.

Other myopic managers are really hoping that they will be able to sell their problems to someone else. They do not wish to make substantial capital expenditures which may not be reflected in the selling price of the building.

(e) the unscathed owner

Not all the owners interviewed were affected by serious choices between return and quality performance. me continued to enjoy strong profit positions through the combinations of higher than average rent levels, efficient control of operating expenses, low rate mortgages and the absence of need for substantial capital expenditures. This type of landlord can maintain and even upgrade building conditions. The unscathed owner has no need to sell and is unlikely to do so.

This ownership type is likely to continue to have an above average performance, unless faced with mortgage refinancing. Mortgage refinancing can be a serious problem for landlords despite rent review whenever mobility rates prevent charging the full amount of financing cost increase. This condition is certainly true in London at present, given the high rates of vacancy and mobility in that city. It may also have been true even in Toronto in non-prime locations, where landlords may have feared loss of tenants should rents increase above those on competitive units. Certainly, a number of landlords expressed a concern over the prospect of higher interest rates reducing their return. This concern of landlords would, however, be reduced condsiderably with the large rent increase scenarios outlined in Chapter 2. In such an environment, large rent increase awards could be passed on to tenants without great difficulty.

(f) the forced-out owner

The forced-out owner is one who has been or is in the process of being forced out of ownership as a result of large negative cash flow losses. Problems that can contribute to this category may include one or more of the following: low rent revenue increases due to vacancies or bad debts; unusually high expenses relative to revenues (several had 80 per cent expense ratios); high debt payments on refinancing; unusually high capital expenditures required. In fact, several of these problems may interact. Low rents may mean capital expenditures being deferred with resulting increases in operating maintenance and increases in vacancy rates as people leave. In this environment, vandalism may increase, producing further cost increases and worsening the vacancy situation. If the mortgage then comes due, the list of problems is complete and further deterioration may occur on all fronts. Indeed, given the poor financial position of the building, the lender may charge a higher than prime mortgage rate.

The open question in the case of the forced-out owner is whether the new owner can turn the building around. Many of the problems described are difficult to reverse. However, a large investor with substantial income from other sources could buy the building at a bargain price, use the losses as a write-off against other income, invest substantial amounts in capital repairs, fire the existing management teams and bring in his own professional staff, get large rent increases through rent review (capital expenditures and new financing) and get rid of problem tenants through evictions or rent increases. A well located, structurally sound building might be brought back in this fashion.

(g) the syndicator

The syndicator is essentially an owner of a new building who is taking advantage of the tax write-offs under the Multiple Unit Residential Building (MURB) provision. This tax advantage may be augmented by government assistance funds (the former Assisted Rental Program, current Ontario Rental Construction Loan).

The two major questions for these buildings are: will tenants accept the larger than average rent increases which typically occur after full occupancy is attained; will the tax losses of the first few years be limited in extent so as to avoid serious cash flow losses now or in the future? Clearly the questions are interrelated in that failure to increase rents to market levels will mean an investment which will not be viable in the longer term as the value of tax losses diminishes.

Market Differences

The section on Total Sample Description (Page 74) provided an extensive set of comparisons between the Toronto and London market. Here, brief consideration will be given to other potential distinctions between groups of buildings.

In general, a few noteworthy results can be reported. In some cases (e.g., high interest renegotiations) the evidence was too thin to base an opinion. In the case of high interest rates, the ability of landlords to pass on increases has not been answered. In other cases, the data did not yield large differences between groups. For example, Table 4.15 presents the results for foreign-owned buildings. While foreign-owned buildings contacted did slightly better than the total respondents, the differences are quite small and the size and nature of the sample should warn against drawing distinctions between foreign and domestic owners.

Table 4.15

Comparison between Median Values
Foreign Owned and Total Respondents

	Foreign Owned	Total
Buildings	12	66
1980 NOI Rate[1]	9.6	9.3
1980 C/C Yield[2]	9.0	6.9
Price Appreciation	4.4	3.6
IRR on Capital[3]	11.6	11.0
IRR on Equity	15.2	13.9

[1]NOI = Net Operating Income.

[2]C/C = Cash on Cash.

[3]IRR = Internal Rate of Return

Source: Based on data collected by Price Waterhouse.

There was, however, one distinction that is worth noting. This involves the performance of uncontrolled buildings which have come onto the market from 1976 on. Of the 14 buildings in this category, 11 were experiencing a negative cash flow in 1980. Table 4.16 presents other financial comparisons. It should be apparent that the existence of controls has not altered the traditional pattern of negative returns to new buildings in their first few years of operation. Indeed, controls may have accentuated this problem in that new buildings have been restricted in the rents they can charge in relation to existing controlled rents. The negative return condition also provides a reason why it may be necessary to increase rents on such buildings in order to assure long-term viability of the investment. Any limitation placed on the ability to increase rents would create serious difficulties for the investors.

The Maintenance Issue

In Chapter 3, the results from the survey in Metropolitan Toronto on maintenance levels indicated that landlords, tenants and site visitors all agreed that maintenance levels were adequate, good or very good and that no significant deterioration had occurred. In Chapter 4, the survey on profits indicated that many landlords were altering their behaviour in cutting costs in a number of areas of activity, including maintenance. The question, then, is which observations are correct?

Table 4.16

Comparison between Median Values
Uncontrolled Properties and Total Respondents

	Uncontrolled	Total
Buildings	12*	66*
1980 NOI Rate	6.7	9.3
1980 C/C Yield	-10.2	6.9
Price Appreciation	1.9	3.6
IRR on Capital	7.3	11.0
IRR on Equity	-7.1	13.9

*Note: Two new buildings involved leased land and are excluded from calculation of medians.

Source: Based on data collected by Price Waterhouse.

We are inclined to believe that both surveys are correct. In doing so, we have in mind the differences in what was measured and the respective features of the two surveys.

The two surveys were actually measuring different things. The Maintenance Survey explicitly concentrated on the output from maintenance activity — clean floors, repaired plumbing, etc. The Rate of Return Survey picked up information on the input into maintenance activity — management strategy and dollars spent. Given that rent review has only been in existence for 5 years at the time of the surveys, it is quite plausible that landlords have, to this date, largely responded by either increasing the efficiency of their maintenance activity (getting the same level of output from fewer resources) or by cutting back marginally in low priority areas that would not greatly affect overall results.

If our interpretation is correct and adjustments to maintenance activity have largely been increased efficiency or marginal reductions, it would be dangerous to assume that this process can proceed indefinitely. There probably exist very real limits to the ability to improve efficiency or reduce non-essential services. Further erosion of financial position as perceived by landlords, then, may start to produce more serious cuts in the level of maintenance services.

CHAPTER 5 — Direct and Indirect Costs

In the last three Chapters the impact of rent review on supply and demand, maintenance and rate of return have been examined. In this Chapter the analysis will focus on a number of other ways in which rent review can have an impact on various people. Consideration will be given to:

- capital gains
- terms of financing
- cost of compliance
- search time for apartment hunters
- sub-optimal location
- shifting municipal tax bases
- direct and indirect government revenue and expenditures
- law and order.

Capital Gains

Some consideration of capital gains has been incorporated into the calculation of the rate of return in the last chapter. It is useful, however, to give further consideration to the capital gains experience of the past decade to highlight the trends relative to inflation in general and to the increase in the price of other real estate.

In Table 5.1, the average and median per unit prices are given for apartment buildings of 20 units and over in Metropolitan Toronto. While some caution must be exercised given the relatively small number of sales, it should be apparent that while apartment building prices generally increased both before and after rent review, the increases were quite low relative to the general rate of inflation and real estate prices in general.

The failure of rental apartment prices to keep pace with other increases in recent years is further highlighted in Table 5.2. Here, average unit prices are contrasted with the prices that would have resulted had apartment value increases kept pace with general inflation. In five of the six political jurisdictions in Metropolitan Toronto, unit values fell relative to inflation. East York was the only exception and this may be due to an abnormally low 1975 value.

Table 5.1

Unit Selling Prices — Metropolitan Toronto 1970 — 1980

Year	TORONTO		NORTH YORK		ETOBICOKE		EAST YORK		SCARBOROUGH		YORK	
	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average
1970	13,060	13,274	12,421	11,714	10,854	10,854	12,000	11,850	14,288	14,035	9,104	9,239
1971	11,328	12,125	13,156	13,035	12,182	11,117	13,834	13,834	13,714	14,482	10,000	10,311
1972	9,838	11,131	13,000	13,608	14,490	14,490	10,147	10,147	10,933	11,217	11,417	11,462
1973	13,510	13,469	12,436	12,921	12,856	14,191	-	-	14,253	14,389	11,581	11,132
1974	12,552	12,620	16,702	15,982	13,468	14,126	13,770	13,770	15,850	15,335	13,700	14,130
1975	13,636	15,550	16,182	16,078	13,833	13,613	12,670	10,803	15,652	15,829	16,216	15,331
1976	13,157	15,675	14,448	14,448	9,000	9,000	14,109	14,109	16,950	16,727	11,042	11,042
1977	15,383	15,492	15,130	14,559	17,857	18,670	14,297	14,297	16,361	17,132	16,896	16,896
1978	16,100	15,456	18,873	18,646	15,552	17,044	15,938	15,953	18,857	18,350	12,455	12,114
1979	16,389	17,994	19,422	18,912	17,714	18,366	19,115	17,838	17,353	17,511	15,245	15,592
1980	17,904	16,373	20,660	19,426	12,267	12,267	17,900	16,842	19,788	19,004	14,849	14,289

Table 5.2

Average Unit Price Versus Inflationary Price

YEAR	A/I*	C.P.I.**	Toronto	North York	Etobicoke	East York	Scarborough	York
1975	BASE	10.8	15,550	16,078	13,613	10,803	15,829	15,331
1976	A		15,675	14,448	9,000	14,109	16,727	11,042
	I	7.5	17,229	17,814	15,083	11,970	17,539	16,987
1977	A		15,492	14,559	18,670	14,297	17,132	16,896
	I	8.0	18,522	19,150	16,214	12,867	18,854	18,261
1978	A		15,456	18,646	17,044	15,953	18,350	12,114
	I	9.0	20,003	20,682	17,431	13,897	20,362	19,722
1979	A		17,994	18,912	18,366	17,838	17,511	15,592
	I		21,544	22,544	18,999	15,148	22,195	21,497

*A= the actual average selling price for that year

I= what the selling price would have been if the base year price had kept pace with inflation.

**Average annual change

Source: Computed from TEELA Market Surveys, Ltd.

This trend confirms similiar evidence collected by L.B. Smith and P. Tomlinson,[1] which is presented in Table 5.3. In addition, Smith and Tomlinson have noted the decrease in the value of rental apartments relative to the values of ownership housing, both freehold and condominium. This highlights the fact that the considerable gains of homeowners should not be confused with the much lower increases for rental apartments.

The actual capital gains experience is relevant to the claim that apartment owners need not make profits from the operation of the building because they can rely on capital gains to produce an adequate return on capital. Clearly this is not so, nor should it be expected. The value of any capital asset to its purchaser depends on that asset's ability to produce profits. Accordingly, any policy measures or market conditions that decrease the ability to make profits can be expected to reduce the value of the asset, which implies lower capital gains or actual capital losses.

Terms of Financing

In both the Chapter on Supply and Demand and the Chapter on Rate of Return, considerable attention has been given to the impact of rent review on the willingness of investors to put equity capital into rental apartments. As M. Denny points out, however:

> To the extent that rent review lowers the net operating income stream, it will lower the feasible level of debt financing at any acceptable risk in the financial markets.[2]

In other words, the existence of rent review may also have a negative impact on the willingness of financial institutions to provide debt financing for rental apartments.

There are several ways in which financial institutions or mortgage insurers can alter their behaviour to deal with the increased perceptions of risk of default that may result from rent review:

[1]Lawrence B. Smith and Peter Tomlinson, "Rent Control in Ontario: Roofs or Ceilings," (Toronto, 1981) (mimeographed). Note this data relates to 6 or more unit buildings versus the 20 and more used above.

[2]Michael Denny, "Who Pays for Rent Review: An Outline," (for the Ministry of Municipal Affairs and Housing, 1981) p.8 (mimeographed).

Table 5.3

Prices of Rental Apartments[1] in Toronto 1974—80

	Average Per Unit Price for Rental Apartment Buildings of 6 or more suites, City of Toronto[2]		Multiple Listing Service Average Sales Prices Metro Toronto[3]		Ratio of the Per Unit Price of Rental Apartments to MLS Prices	
	Current $	Constant[4] 1975 $	Residential Dwellings	Condominium Apartments	Residential Dwellings	Condominium Apartments
1974	15,407	17,062	52,806	35,031	.292	.440
1975	18,903	18,903	57,581	35,959	.328	.526
1976	17,617	16,388	61,389	37,027	.287	.476
1977	16,766	14,441	64,559	37,596	.260	.446
1978	17,730	14,027	67,333	38,959	.260	.455
1979	16,901	12,238	70,830	43,316	.239	.390
1980	17,429	11,459	75,694	46,754	.230	.373

Sources & Notes

[1]L.B. Smith and P. Tomlinson.

[2]Apartment prices calculated from Teela Market Surveys, Ltd, Apartment Surveys, Toronto.

[3]Multiple Listing Service Prices provided by the Toronto Real Estate Board.

[4]Constant dollars based on the Consumer Price Index.

- reduction or elimination of lending on residential rental buildings;
- increases in interest rates over that charged on other lending;
- decrease in acceptable loan to value ratios;
- requirement of additional collateral as security in addition to the building itself.

Should financial institutions withdraw or substantially stiffen the terms of lending on rental apartments, this can be expected to accentuate the negative impacts on supply and increase the burden of financing costs to both landlords and tenants. As of this time, however, no evidence exists on this problem.

Costs of Compliance

The cost of compliance to rent review legislation may be a very real cost to landlords and especially to small landlords. Large corporate landlords would have always kept well organized records of all their financial transactions. They would almost always have legal assistance on call. Not so with the small landlord. Most do not have accounting and legal advice on staff and found that the costs involved in going through the review process was more than the value of the increase sought. Under rent review these costs can be passed on to tenants.

There are other than financial costs involved in compliance. These may be thought of as the disutility of dealing with a government agency and the problems inherent in raising a conflict situation between the landlord and the tenant. It also means that the landlord or someone he hires must be cognizant of all the rules relating to cost pass-through in order that he be able to take advantage of the rules without overstepping them.

Search Costs

It takes time to look for an apartment. It takes more time when vacancy rates are low. It will also take more time when some units rent for amounts well below average, as people keep looking for 'bargains'.[3]

In that rent review has contributed to low vacancy rates and further results in locking in low rents in certain buildings producing 'bargains', rent review can be expected to increase the amount of time people spend hunting for rental units whenever they enter the market (new households, new arrivals in an urban area) or change units (for whatever reason).

[3]M. Denny, p. 14.

Sub-Optimal Location

An individual tenant's location within an urban area is determined by a number of factors:

- rental cost
- availability of units
- income level
- location of job
- location of schools
- location of shopping
- location of friends, etc.

Over time the relative importance of these factors will change, the accessibility to the other locations will vary and incomes will increase or decline. In an uncontrolled market, the rent in any location will vary according to the overall affect of these factors on the population at large. And given these changes in rent levels and the other factors, people will decide to move or remain in the same unit. Thus, one can expect normally that tenants will change their place of residence as their needs and resources vary.

With rent review however, rents will not respond fully to changes in the desirability of various locations. This will reduce the responsiveness of tenants to changes in the various factors. This may become quite serious when it is combined with generally low vacancy rates or a specific unavailability of units in a location that has become more desirable for the household. Under such circumstances, for example, tenants might not be able to move, say, from Ajax to Oakville in response to a job change from the one area to the other — thus considerably increasing commuting time. Another example would be an inability to acquire a larger unit close to schools as the family size changes.

Some dispute exists as to the importance of these factors in other jurisdictions.[4] As of October, 1981, Table 5.4 indicates, that even in Toronto, about 30 per cent of all units experienced a change in tenant in 1980 - 1981. This is a substantial level of mobility. It will be important to continue to monitor this measure, however, in that this situation may well change with an increasing rental shortage.

[4]See J. Barry Cullingworth, "Rent Control and Redistribution," (for the Ministry of Municipal Affairs and Housing, 1981) pp. 16-20 (mimeographed).

Table 5.4

Renter Mobility During The Period
1980 to 1981

Municipality	NON-MOVERS	MOVERS			Total	Sample Size
	Rented Same Unit (%)	Resided in Same City (%)	Resided in Other City (%)	Resided in Other Country (%)		
Metro Toronto	70.4	22.1	6.4	1.1	100	751
Hamilton	64.2	24.1	11.2	0.5	100	570
London	55.3	29.8	14.1	0.8	100	745
Windsor	56.8	30.9	10.5	1.8	100	686
Ottawa	60.8	24.8	13.1	1.3	100	704
Thunder Bay	57.0	29.0	12.9	1.1	100	719
Sudbury	62.2	23.9	13.1	0.8	100	862

Source: Rental Market Survey in Seven Ontario Cities, October 1981, (Ontario: Ministry of Municipal Affairs and Housing, 1982).

Shifting Municipal Tax Base

In other jurisdictions, tax collections from rental buildings have fallen either because assessments are based on market values which are lowered by rent review or because buildings have deteriorated and assessments are based on physical condition. In either event, the decrease in tax revenues from rental buildings implies either a corresponding increase in tax burden on others (e.g., homeowners) or a decline in municipal expenditures and services.[5]

In Ontario, at this time, there is no reason to believe that such a shifting of tax base has occurred to any great extent. For one thing, the Province does not have full market value assessment in most areas.[6] Another factor is that serious physical deterioration has not occurred in Ontario to this point (See Chapters 3 and 4 above). Finally, rental property is generally over-assessed relative to ownership property so that a reduction in the tax burden on rental property would probably improve the fairness of impact of the tax, at least for reasonably small changes in assessment.

Government Revenue and Expenditures

A recent paper by L.B. Smith and P. Tomlinson[7] states that, in 1980, rent review cost all levels of government more than $150 million in the form of lost revenues and direct or indirect expenditures. In that the direct cost of administering the rent review program was about $5 million in 1980, it makes a considerable difference if the Smith—Tomlinson argument is correct.

Table 5.5 summarizes the calculations performed by Smith and Tomlinson. These estimates attribute $30.2 million of extra spending to rent review and estimate tax losses to be $122.2 million for 1980. Thus, rent review is said to have a cost to all governments of some $152.4 million, with 49.2% (or $75.2 million) being federal, 29.7% (or $45.2 million) being provincial, and the remaining 21.0% (or $32.0 million) being municipal.

Table 5.5 lists the costs attributed to rent review by Smith and Tomlinson and notes the basis on which these estimates were made. In Table 5.6 the differences between our estimates and those of Smith and Tomlinson are given. In general, it is reasonable to attribute the costs specified by Smith and Tomlinson to rent review, although in a number of cases our estimates are somewhat lower. The Ministry's estimate of extra expenditures for 1980 is $16.1 million, while the tax loss for the same year is set at $83.8 million. The total cost to governments then is

[5]See G. Sternlieb & J.W. Hughes, "Rent Control's Impact on the Community's Tax Base," The Appraisal Journal, XLVII, 3 July 1979, pp. 381-394.

[6]Use of Section 86 (3) of the Assessment Act does not alter the burden between various classes of property.

[7]"Rent Controls in Ontario: Roofs or Ceilings"

Table 5.5

Calculation of Lost Revenue and Expenditure Costs by Smith and Tomlinson for 1980

Item	Est. $M	Basis
Government Expenditures		
Administrative cost of Rent Review	7.5	has fluctuated between $5-$10 million
Assisted Rental Program	18.0	40,000 units in Ontario, assume $900 per unit; in 1980=$36M; assume half due to rent review
Ontario Rental Construction Program	4.7	
	30.2	
Government Cost Revenues		
M.U.R.B.	7.5	Dept. of Finance estimate for Canada $45M. Ontario=one-third of the starts of multiples in applicable time period; assumes 50% due to rent review
Reduced income tax from landlords	54.4	1,000,000 units, equilibrium rent increase 7-8.75% average rent @ $300 = $238M less 5% higher services = $136M x 40% marginal tax rate
Reduced capital gains tax	26.0	assume: proportion of apartment units sold in Toronto 33% higher than in Province as a whole; the number of sales were unaffected by rent review; the real value of buildings decline in absence of control by only 10%, rather than the actual 40%
Provincial capital tax	2.3	assume: 75% of higher prices financed by the debt.
Municipal property taxes	32.0	rental stock down 40,000 units, average $800/unit
Total Lost Taxes	122.2	
Total Expenditure & Lost Taxes	152.4	

Table 5.6

Calculation of Lost Revenue and Expenditure Costs Comparison of Smith and Tomlinson with Ministry

Item		S & T $M	Ministry $M	Reason
1.	Administrative cost of Rent Review	7.5	4.7	Actual expenditure for 1980/81 fiscal year.
2.	Assisted Rental Program	18.0	8.8	Use actual 1980 cost
3.	Ontario Rental Construction Grant	4.7	2.6	$5.2 million actual 80/81 fiscal year x 1/2 responsibility for rent review (same as ARP)
	Total Expenditures	30.2	16.1	
4.	M.U.R.B.	7.5	7.5	
5.	Reduced income tax from landlords	54.4	20.0	only 800,000 covered by controls (not 1,000,000); average rent closer to $275 than $300; tenants will spend portion of rent saving, therefore higher incomes elsewhere (assume 1/2 spent) $54.4 \times \frac{800,000}{1,000,000} \times \frac{275}{300} \times 1/2 = 20$
6.	Reduced capital gains tax	26.0	26.0	
7.	Provincial capital tax	2.3	2.3	
8.	Municipal property tax	32.0	28.0	median tax $706, not $800.
	Total Lost Taxes	122.2	83.8	
	Total Expenditures & Lost Taxes	152.4	99.9	

$99.9 million. The Ministry estimates would change the intergovernmental shares to 43.7% (or $43.6 million) federal, 28.3% (or $28.3 million) provincial, and 28.0% (or $28.0 million) municipal.[8]

While some of the individual cost estimates are substantially different, this should not be allowed to divert attention from the major point that is being made by Smith and Tomlinson — that rent review has a far greater impact on government budgets than the direct expenditures for the Residential Tenancy Commission. Therefore, all taxpayers, both tenants and owners, have a financial stake in the existence of rent review.

Also valid is the point made by Smith and Tomlinson that the level of government imposing the controls, the Province, bore much less than half the cost of the program. Hence, the existence of rent review is not exclusively the concern of one level of government.

Law and Order

The increase in practices such as key money or a black market are generally negative to society as a whole. Key money is the practice of a tenant's paying out money in order to get to the top of a waiting list for an apartment and be given the key. A black market in apartments operates when a new tenant must purchase furnishings or anything else from a departing tenant or other person at an inflated price in order to gain possession of the unit. From a landlord's point of view, if he is collecting the key money, he may find it a good way to do business. Under tight housing market conditions, tenants agree to be accomplices to the landlord's violation of the law. Even if both parties are willing participants in the evasion of the law, harm may be done. Any action that undermines part of the law inevitably increases the degree of disregard for the law in general. In that the social acceptance of the legal system is an essential component of any system of government, this cost would indeed be a significant one.

The issue of violation of the law is of course related to that of the relation of the law to socially acceptable concepts of justice. We will return to this question in Chapter 9 below.

[8]While municipalities can raise the mill rate to meet required revenues, there are limits to the extent this can be done. More important, the ultimate cost is borne by the taxpayers either through higher mill rates or reduced services or both.

CHAPTER 6 — Affordability

One of the principal arguments that is made in favour of the continuation of rent review is that it is necessary in order to allow tenants to have access to affordable rental housing. Decontrol, in this view, would cause a significant increase in the size of the affordability problem.

It is necessary to distinguish affordability from other related issues of housing or income distribution policy. It will then be useful to discuss several alternative approaches to measurement of affordability. Given the selection of an appropriate measure, attention is then given to the results according to this measure, along with consideration of a number of factors that bear on the interpretation of these statistics. Finally, the interaction between rent review and affordability will be explored along with consideration of alternative affordability measures.

Affordability as a Problem

Housing affordability problems may be viewed from a number of perspectives. One may view the problem as primarily one of the high cost of housing, another as one of insufficient income and a third as housing cost in relation to income. The importance in viewpoint shows up in the policy focus of each of these views, with the first group focusing on housing subsidy and supply programs, the second on income redistribution policies and the third on measures directly affecting the shelter cost of households. The focus of this chapter is on the third view.

In choosing this focus, the alternative of exclusive reference to housing costs alone was rejected in that little problem would seem to be caused by increases in the housing cost of tenants that were outpaced by the rate of income increase.

This focus also rejects the notion that income alone should be considered. Some would claim that the housing affordability problem is really only an income problem and that analysis should thus focus on the causes and cures for low income. While there is merit to this view, there are at least three reasons for rejecting this approach here. First, one cannot ignore public perceptions. The issue is popularly defined in terms of housing affordability and there is considerable importance in addressing public concerns. Second, given the experience associated with the last attempt to recast the income distribution process in Canada[1] and given the current state of federal-provincial negotiations on fiscal arrangements, it seems highly unlikely that comprehensive

[1]Here reference is to the unsuccessful negotiations between federal and provincial governments that followed release of: Marc Lalonde, Working Paper on Social Security in Canada (Government of Canada: National Health and Welfare, 1973)

reform to income maintenance programs will occur in the near future. Accordingly, consideration of housing oriented solutions seem to be the more plausible approach. Third, any solution to income problems that ignores large variations in housing costs across the Province will prove to be either inadequate for those living in high cost areas or enormously expensive if everyone in the Province is provided an income that would enable an adequate standard of living in the highest cost area.[2] For all these reasons a joint focus on housing costs and incomes is appropriate.

Alternative Measures — General Considerations

In considering housing affordability standards, one must recognize that such standards are in practice determined by social conventions. That is, there is nothing scientific that determines what is to be identified as an affordability problem.

A number of considerations go into the formation of opinions on the acceptable relation of rent to income. Historical experience and trends over time undoubtedly play a considerable role. Changes in perceptions can, however, occur.

In a time of increasing affluence, for example, people may regard it as appropriate for households to spend a lower proportion of their incomes on housing accommodation. Another possibility is that people could come to accept that the costs of producing and financing housing have undergone a fundamental upward shift and that the new economic realities dictate that larger expenditures on housing are required to insure the provision of an adequate quantity and quality of rental housing.

In this study, the basic approach used in the measurement of affordability problems uses the ratio of rent to income. The major alternative approach is based on a budgeting technique that specifies both the cost of housing and the minimum amount of other goods and services and compares these needs with household income. As such, the budgeting method measures more than the housing affordability gap — it measures the total shortfall of income required for all purposes. It would, therefore, seem to be an overstatement of the degree to which housing costs produce financial difficulty. Indeed, if the expenditure for other goods and services equalled the households' income, this measure would indicate that the housing affordability gap would be equal to the entire amount of housing expenditure — or alternatively viewed, that the housing affordability gap could only be eliminated if the household were to receive its housing at zero cost. These problems would seem to argue against the use of a budgeting approach in defining of housing need. On the other hand, such a method might well be useful in the definition of total income need.

[2]The notion of the importance of regional housing cost variations to income transfer policies is raised in H.J. Aaron, Shelter and Subsidies (Washington, D.C.: Brookings Institution, 1972) pp.167-173.

Rent-to-Income Ratios

The number of households defined to have an affordability problem will be greatly affected by the choice of rent to income ratio selected. In 1978, the number experiencing a problem was 152,000 if a 35 per cent ratio was used, but 343,000 if a 20 per cent threshold was chosen (See Table 6.1).[3] In arriving at a choice one might consider the severity of the financial problems faced by the household. Statistics Canada uses a Revised Low Income Cutoff which is based on the income required by a family in order to have its typical expenditures on food, shelter and clothing not exceed 62 per cent of income. One can see from Table 6.2 that the choice of a threshold is not critical in describing the housing affordability problem of the 'poor', but is critical as regards the housing affordability problems of the 'near-poor'.[4] That is the number of 'poor' households with a problem rises by 9,000 as one goes from a 30 per cent to a 20 per cent threshold, whereas the number of 'near-poor' with a problem more than triples from 69,000 to 216,000.

Another set of considerations relate to various other characteristics of problem households. The greatest reduction in the numbers with problems as one goes from 20% to 30% ratio occurs for the fully employed, for other than one person or single parent families, for those under 65 and where there are two or more earners. The least reduction is in those classes which experience the greatest problems: those not in the labour force (e.g., retired or on welfare), single parent families, those over 65 and households with no income earners.

[3]These figures may be somewhat inflated by the fact that current rents are compared to previous year's income. On the other hand, the 1978 unsubsidized renters exclude those renting in the private market but receiving some assistance from family members.

[4]The great majority of non-poor with housing affordability problems had below average incomes, hence the term 'near-poor'.

Table 6.1

Unsubsidized Rental Households with Affordability Problems at Various Rent to Income Ratios for Ontario, 1978

Rent to Income Ratio	Per Cent with Affordability Problem	Number with Affordability Problem (thousands)
20% or more	42.7	343
25% or more	30.2	242
30% or more	23.2	187
35% or more	18.9	152

Source: Based on Table 3.1 in J. Miron, "The Affordability of Rental Housing in Ontario: Empirical Findings" pg. 14 which in turn used unpublished data from Statistics Canada Household Income, Facilities and Equipment, 1978.

Table 6.2

Affordability Problems of Low Income and Higher Income Unsubsidized Rental Households in Ontario, 1978

Rent to Income Threshold	(thousands) Housing Affordability Problem		No Housing Affordability Problem
	Below Low Income Cutoff	Above Low Income Cutoff	
20%	127	216	459
25%	125	117	560
30%	118	69	615

Source: Tables 3.3, A3.3, B3.3 in J. Miron, based on unpublished data from Statistics Canada, 1978 HIFE.

Table 6.3

Characteristics of
Households With An Affordability Problem
Among Ontario Unsubsidized Renters
1978

Category	20% Threshold No. 000's	20% Threshold Incidence %	25% Threshold No. 000's	25% Threshold Threshold %	30% Threshold No. 000's	30% Threshold Incidence %
Labour Force Status of Head						
Fully Employed	133	28.3	68	14.5	40	8.5
Non-Participating	94	72.9	84	65.1	75	58.6
Others	116	56.8	90	44.2	72	35.3
Household Type						
One Person	160	61.2	118	45.4	95	36.4
Single Parent[1]	41	71.1	32	56.0	29	51.0
Others	142	29.3	92	18.9	63	13.0
Age of Head						
Under 25	75	47.8	53	33.9	41	25.9
25 - 54	168	35.5	109	23.1	82	17.4
55 - 64	37	46.1	25	31.4	*	*
65 and Over	63	68.0	54	59.1	46	49.7
Number of Earners						
None	90	79.7	82	72.3	74	65.0
One	181	51.1	120	34.0	89	25.0
Two or More	71	21.3	40	11.9	25	7.4
TOTAL	343	42.7	242	30.2	187	23.3

[1]with children under 16.

*Indicates fewer than 20,000 households in category.

Note: Columns may not equal total due to rounding.

Source: J. Miron, Tables 4.2, A4.2, B4.2 based on unpublished data from Statistics Canada, 1978 HIFE.

Adequacy of Accommodation

In addition to affordability, there is also the question of whether the housing being occupied by the household is adequate to its needs. Three measures of this are: the availability of separate housing units, the availability of sound housing with standard facilities and the absence of overcrowding or underutilized space.

Over the past 30 years there has been a very dramatic reduction in the number of families not maintaining a separate household (i.e., 'doubled up'). In 1951, some 12 per cent of families did not have separate accommodation, this fell to 7 per cent in 1961 and to 4 per cent in 1971. In 1976, this percentage had been reduced to under 2½ per cent. One suspects that in a number of the remaining cases families are doubled by choice — people who prefer to live with relatives or friends in a joint household arrangement.

As regards physical adequacy, almost all dwellings in Ontario have basic essential facilities. In 1979, 99.6 per cent of dwellings had running water, 99.3 per cent had bath or shower, 99.1 had a toilet and 99.6 per cent had a refrigerator.[5] With regards to physical repair, the Chapter on Maintenance has indicated generally high standards. A further qualifier to the problems that do exist is provided by J.B. Cullingworth:

> As already indicated, any measure of affordability has to involve some concept of adequacy (or "common standard" or "norm"). This gives rise to two inter-related difficulties — conceptual and empirical. Conceptually a household may be able to afford (i.e., have sufficient income to obtain) decent housing, but may prefer for one of a multiplicity of reasons not to incur such expenditure (or — what amounts to the same thing — does not wish to move from currently inadequate housing). In short, the standard of adequacy employed may be at variance with the attitudes of some (unknown proportion of) households.
>
> The empirical difficulty may — or may not — be different: it is simply a fact that many who could afford adequate housing live in inadequate housing (whether by choice or not). This is clearly seen in the 1974 SHU data for Toronto. For example, while the proportion of 'poor' housing in Toronto is 4.7%, the proportion of the highest income group ($22,500+) living in poor housing was actually 4.8%. In broader aggregations the fact remains that poor housing and incomes are not 100 per cent correlated.[6]

[5]Central Statistical Services, Ontario Statistics 1980 (Toronto: Ministry of Treasury and Economics, 1980) pp. 275-278. (Based on Statistics Canada's Household Facilities and Equipment).

[6]J. Barry Cullingworth, "Housing Affordability," (for the Ministry of Municipal Affairs and Housing, 1981) p.13; Reference is made to Canada Mortgage and Housing Corporation 1974 Survey of Housing Units, Cross-Tabulation of Dwelling Units and Households, Survey Area No.19. Toronto (Ottawa: C.M.H.C., 1974) Table 3.18.

As regards the quantity of housing consumed, reference may be made to Table 6.4.

Table 6.4

Quantity of Housing by Rent to Income Group

	(thousands of households)	
	Under 25%	25% or More
Underhoused	126	36
Overhoused	125	51
Adequate	305	155

Source: J. Miron, Table 5.2 based on unpublished data from Statistics Canada, 1978 HIFE.

Given a 25 per cent threshold:

> A very simple definition of an overhoused, underhoused, or adequately-housed household is used here. For each reference group the modal number of bedrooms is found. For example, in those households with 2+ persons and no children, the modal size of dwelling is a 2 bedroom unit. Any household occupying a larger dwelling (i.e., with more bedrooms) is overhoused and any occupying a smaller unit is defined to be underhoused. Among 2+ person households with no children there are for example 110,000 underhoused and approximately 33,000 overhoused households by this definition.[7]

If 25 per cent rent to income ratio for adequate sized housing was taken as the standard, those paying 25 per cent or more of income on shelter and either under or adequately housed might be deemed to have a definite affordability problem. Those paying under 25 per cent and either adequately or overhoused, might be said to not have a problem. But those who are underhoused and paying under 25 per cent of income

[7]John Miron "The Affordability of Rental Housing in Ontario: Empirical Findings," (for the Ministry of Municipal Affairs and Housing, 1981) p. 28 (mimeographed).

on housing, might have to pay over 25 per cent of income were they to obtain adequately sized housing. Conversely, those who are overhoused and paying 25 per cent or more of income on housing might be able to solve their apparent affordability problem by moving into an appropriate sized unit. Uncertainty, therefore, exists as to whether households in these last two groups have an affordability problem when housed in an adequate sized unit.

In order to test the proposition that affordability problems might be created or resolved by the movement into appropriate sized housing, some estimates were developed on the assumption that underhoused and overhoused households would pay the median rent of an appropriately sized housing unit in that urban area. Using 1976 data, the number of problem households changed from 297,000 using actual rent to 312,000 using adjusted rent. Given that this difference is only about 5 per cent, and given the other uncertainties involved in classification of households into problem categories, it was decided that other computations need not involve the rather complex adjustment required to determine affordability problems on a size adjusted basis.[8]

In summary, the numbers with affordability problems are not greatly affected by considerations relating to the quality and quantity of housing consumed by the household. Accordingly, no such adjustments will be made in subsequent analysis.

Size of Problem

In estimating the total size of the problem and its trend over time, it is necessary to confront an unfortunate statistical problem. All the estimates used in the study are based on unsubsidized rental households. The major intent of this was to exclude publicly assisted tenants who are not covered by rent review. In the years 1972, 1974 and 1976, subsidized renter households included publicly assisted tenants and also those assisted by employers. In 1978, however, the definition of subsidized was extended to include tenants who received assistance from a relative. As a result, this extension produced a large drop in the number of unsubsidized rental households. (See Table 6.5)[9]

[8] J. Miron, pp.30-32.

[9] J. Miron p.4.

Table 6.5

Weighted Counts of
Unsubsidized Rental Households
In Ontario 1972 - 1978

Year	Households 000's
1972	759
1974	821
1976	905
1978	802

Source: J. Miron, Table 1.1 computed from unpublished data from Statistics Canada, 1978 HIFE.

Hence, it is likely that the number of private market tenants in 1978 who had affordability problems will be understated by the data. John Miron points out that: "the numerical importance of this definitional change cannot be assessed."[10]

While it is true that it is technically impossible for the computer to separate out 'the subsidized by relatives' group, one may explore the sensitivity of the results to assumptions on the number of problem households that have been omitted from consideration.

If we assume that in absence of the definitional change: (1) the total number of households would have increased by the same annual average from 1976 to 1978 as in the 1972 to 1976 period; and (2) that the incidence of problem households was similiar for households assisted by relatives as for unsubsidized renter households; then the number of problem households in 1978 on the 25 per cent threshold would rise from 242,000 to 295,000. If we assume that the size of the problem is the same for the subsidized-by-relatives group as for the other problem households, then the total dollar size of the problem (the affordability gap) can be computed as in Table 6.6. It is apparent that the large drop in the recorded HIFE data might, to a considerable degree, be due to changing definitions of unsubsidized rental households.

[10] J. Miron, p.38.

Table 6.6

Calculations of Affordability Gap in Ontario 1972 to 1978

	No. of Unsubsidized Rental Households (000's)	Problem Households			Total Affordability Gap ($millions)
		Incidence (%)	Number (000's)	Average Gap ($)	
20% Threshold					
1972	759	45.6	346	640	222
1974	821	46.6	383	782	299
1976	905	49.5	448	1045	469
1978	802	42.7	343	1129	387
1978*	978	42.7	418	1129	472
25% Threshold					
1972	759	32.2	244	637	155
1974	821	34.1	280	780	218
1976	905	34.4	311	1127	351
1978	802	30.2	242	1139	276
1978*	978	30.2	295	1139	336
30% Threshold					
1972	759	23.5	179	658	118
1974	821	26.4	216	785	170
1976	905	27.1	246	1138	280
1978	802	23.2	186	1137	212
1978*	978	23.2	227	1137	258

*Recalculation by Ministry of Municipal Affairs and Housing using adjustment described in text.

Source: J. Miron Tables 6.3, A6.3, B6.3 based on Statistics Canada, 1972, 1974, [illegible]

Indeed, if one assumed that the incidence of problems was higher among those receiving assistance from relatives or if the average size of their problem was higher, or if the number of those assisted by relatives is higher than assumed here, the 1978 figures could have shown a clear increase in the affordability gap.

Although we can never know the true answer to this problem, that the characteristics of problem households, for the most part, do not change significantly from 1976 to 1978,[11] gives some support to an assumption that those renters subsidized by relatives are roughly similiar to other renters. At any rate, this seems closer to the truth than the assumption that none of those receiving money from relatives are left in an affordability problem situation (the assumption implicit in making no upward adjustment at all).

In addition to gauging the total size of the problem in Ontario, it is also useful to look at the affordability gap in relation to the incomes of tenants. From Table 6.7 it can be seen that the size of the gap is relatively significant in relation to those who are in the problem group. It is also apparent that extending the threshold downward results in a substantial reduction in the degree of seriousness of the average affordability problem.

Table 6.7

Affordability Gap as a Per cent of Income in Problem Households in Ontario 1972 to 1978

Year	20% Threshold	25% Threshold	30% Threshold
1972	12.2	15.6	20.3
1974	13.9	18.0	22.0
1976	15.1	20.1	24.0
1978	13.2	17.1	20.7

Source: J. Miron, Table 6.3, A6.3, B6.3 based on unpublished data from Statistics Canada, 1978 HIFE.

[11]See J. Miron, pp.13-23.

Rent Review and Affordability

It is self-evident that, if one defines affordability in terms of the ratio of rent-to-income, a policy that works to hold down the rate of rent increase may well have an impact on affordability problems. It follows that one can evaluate rent review from the perspective of its contribution to the resolution of affordability issues. It does not, however, follow that rent review is solely or primarily an instrument aimed at improving affordability — the next three chapters will explore other aspects of rent review's contribution to other goals.

It may be well to reflect at the outset on why rent review is not, and cannot be, designed with a focus on improving affordability. The reason rent review cannot be so designed is that any attempt to include tenant income in the determination of rents would impose severe financial hardship on landlords renting to those with low incomes. Rent revenues would fall and, therefore, in many cases profits would be squeezed to the point of elimination or loss. Faced with this prospect landlords would develop a strong bias against renting to those who had low incomes making it increasingly difficult for those tenants to acquire rental units. For those landlords who had such tenants to start with, falling profits could be expected to lead to the various adjustment patterns outlined in the Chapter on Rate of Return. In all, these patterns could be expected to produce considerable havoc in the low income end of the rental market.

Even though rent review cannot be focused primarily on affordability problems, it is possible to evaluate rent review's contribution and to compare it with other approaches.

One approach to measuring rent review's impact is a comparison of the historical trend in the number of households with affordability problems, the size of their problems, and the change in the affordability gap over time. To some extent, this was outlined in the last section. It was pointed out there, that the pattern of affordability problems indicated growth during the 1972 to 1976 period and a decrease from 1976 to 1978. However, the latter trend may well reflect (to an unknown extent) the affect of the definitional change regarding 'subsidized renters'. In addition, Miron confirms that the decline in the incidence ratio from 1976 to 1978 is not statistically significant and that other changes may be responsible for any changes that may have occurred.[12]

A second approach attempted by Miron, studies the relationship between the rent component and the total Consumer Price Index (CPI). From 1961 to 1976 Canada-wide data indicated that the ratio of the rent component to the total CPI was 53 per cent. From 1976 to 1979 the

[12] J. Miron, pp. 38-39. Other factors that may have reduced the incidence of affordability problems include increases in the supply of geared-to-income housing, demographic factors and existence of Assisted Home Ownership Program (AHOP) which drew low income earners into the ownership market.

same ratio was 61 per cent. Thus, on a Canada-wide basis, rent increases were a higher proportion of the increase in the total price index.[13] However, given the rapid escalation in all prices, the real level of rent as measured by the CPI fell by more in the later period. In addition, this approach is subject to all the limitations of the rent component of the CPI.[14] Thus, given this diversity of perspectives and the limitations inherent in the CPI rent index, it appears this approach yields inconclusive results.

The third method developed by Miron looks at the impact of rent changes on the number of tenant households with affordability problems.[15] In order to arrive at an estimate of the total impact one must combine information on the number of households at various rent-to-income ratios with the impact on rent levels of rent review.

Table 6.8 indicates the number of households with affordability problems in 1978 assuming various changes in rent levels. A 5 per cent reduction in rents would have reduced the number with affordability problems by 6 per cent in that year. A 10 per cent reduction would have reduced problem households by 13 per cent. Conversely, a 5 per cent increase in rents would have increased the number of problem households by 8 to 10 per cent, while a 10 per cent increase would have produced a 16 to 19 per cent rise in the number with problems.

Estimates of the impact of rent review on rent levels can be derived from the supply and demand model outlined in Chapter 2 above for Toronto and London. For 1980, rents in Toronto were reduced in real terms by 12.1 per cent, while the reduction in London was 0.8 per cent.

For areas other than Toronto and London other methods of estimation must be used. For areas with C.M.H.C. vacancy rates a method developed by L.B. Smith, may be used.[16] According to Smith, rents are estimated to increase in real terms by 2.5 per cent for every one per cent of vacancy below 5 per cent vacancy level. For areas other than Toronto and London, the average vacancy rate in 1980 was 2.9 per cent. This implies an average real rent increase of 5.25 per cent in absence of rent restrictions. For Toronto, the Smith method yields an increase of 10.75 per cent, while London would have no real increase according to this method. The average rent change for all areas with vacancy rates, including Toronto and London, would be 7.25 per cent.

[13] J. Miron, pp. 38-41.

[14] See G. Fallis, Housing Programs and Income Distribution in Ontario (Toronto: University of Toronto Press, 1980) pp 26-37.

[15] J. Miron, pp.42-43.

[16] Lawrence B. Smith, "A Note on the Price Adjustment Mechanism for Rental Housing," American Economic Review, June 1974, pp.478-481.

If one were to substitute the values for Toronto and London from the supply and demand model for Smith's estimates but retain Smith's estimates for other areas, and further assume that areas without CMHC vacancy rates had 3 per cent of their units vacant,[17] then the average impact on rents would be 7.9 per cent.

For the purposes of the calculations that follow a mid-range impact of 7.5 per cent will be used.

Table 6.8

Number of Problem Households
Assuming Various Changes in Rents
in Ontario in 1978

Per cent Changes in Rents	Threshold		
	20%	25%	30%
10% higher	401,700	287,700	217,000
5% higher	373,500	265,900	202,900
No Change	342,500	242,000	187,200
5% lower	321,400	227,600	175,900
10% lower	297,900	211,600	163,300

Source: J. Miron, p. 43, based on unpublished data from Statistics Canada, 1978 HIFE.

These estimates confirm that rent review does have an impact on affordability. Some questions may be raised, however, as to whether rent review is the optimal way to accomplish affordability objectives. In this chapter consideration will be given to the efficiency of rent review as an affordability measure, to the alternative of a rental allowance and to the ways in which tenants view the desirability of receiving assistance in the form of rent review.

The efficiency of rent review as an affordability measure can be measured by the share of benefits from the program that go to those with affordability problems as a proportion of the total costs of the program. Estimates of this efficiency are computed for 1980. Program costs here are taken as the cost to the landlord in terms of rent reduction plus the direct and indirect costs to government calculated in

[17]Three per cent being the average Ontario C.M.H.C. vacancy rate outside Toronto.

Chapter 5 above. The total cost to landlords in terms of rent reduction was derived from the combination of the supply and demand model outlined in Chapter 2 above, and the estimates based on the method developed by L.B. Smith. The distribution of these costs among households was not available for 1980 at the time of writing. Here it was assumed that the distribution was the same as for 1978.

As one can see from Table 6.9, the efficiency of the program varies dramatically with the definition of affordability threshold. If one argues that no tenant should pay over 20 per cent of income on rent, then one finds that 46 per cent of the rent savings, and under one-third of the total cost of the program accrue to those with affordability problems. For the more usual 25 per cent threshold about one-third of the rent savings goes to problem households and this is equal to about one-fifth of the total cost of the program. For the 30 per cent ratio, less than one-quarter of the rent savings goes to those with affordability problems and about one-seventh of the program costs go to relieving affordability pressures.

Regardless of which threshold is used, rent review cannot be viewed as an efficient means of approaching the affordability problem. A one-third target efficiency is not a good performance. Still worse is the performance in meeting the problems of those in greatest need.

An alternative approach to meeting affordability needs is a rental allowance. Advocacy of rental allowances as an alternative to rent controls in Canada goes back almost a decade to the review of low income housing policy by M. Dennis and S. Fish.[18] Several provinces now have programs which provide assistance to those in the private market who would otherwise be paying excessive amounts of their income on rents. Estimates of program costs depend on a variety of considerations, including affordability threshold used, formula adopted, groups covered and program participation by eligible households. Using the 30 per cent threshold, the formula used in the British Columbia S.A.F.E.R.[19] program, coverage of all with affordability problems and 100 per cent participation, the total annual cost for Ontario would be about $200 million. About one-quarter of this would go to senior citizens, another quarter to families with children and the other half to single people and couples under 65 years of age. This cost would be less than the cost in 1980 to both landlords and governments combined of the rent review program. All those with affordability problems would be assisted, and the formula would not provide benefits to those who do not have an affordability need. Thus, an allowance scheme would be a more efficient way to address problems of excessive shelter payments by renters.

[18]Michael Dennis and Susan Fish, Programs in Search of a Policy: Low Income Housing in Canada (Toronto: Hakkert, 1972), pp. 354-366.

[19]SAFER: Shelter Allowance for Elderly Renters.

Table 6.9

Efficiency of Rent Review as Affordability Measure

		Threshold 20%	25%	30%
1.	Rent of Problem Households:			
	Income x Threshold Rate ($)	1,713	1,675	1,648
	Affordability Gap ($)	1,129	1,139	1,137
	Total Rent ($)	2,840	2,814	2,785
2.	Number of Problem Households	343,000	242,000	186,000
3.	Total Rent of Problem Households ($)	974.0M	681.0M	$518.0M
4.	Amount of Rent Savings - Problem Households ($)	73.1M	51.1M	38.8M
5.	Amount of Rent Savings - All Households ($)	159.2M	159.2M	159.2M
6.	Per cent of Rent Savings to Problem Households (%)	45.8	32.1	24.4
7.	Other Cost of Rent Review ($)	99.9M	99.9M	99.9M
8.	Total Cost of Rent Review ($)	259.1M	259.1M	259.1M
9.	Per cent of Rent Savings of Problem Households to Total Costs of Rent Review (%)	28.2	19.7	15.0

Source: J. Miron, Tables 6.2, 6.3, A6.2, A6.3, B6.2, B6.3, based on unpublished data from Statistics Canada, 1978 HIFE and Ministry of Municipal Affairs and Housing estimates.

Notwithstanding these comments, rent review receives considerable support as an affordability measure. Partly, this is due to the fact that the poor probably prefer to receive assistance that assists a wide range of income earners thereby increasing the range of support for the program and lessening the stigma that is attached to low income support programs. In addition, many taxpayers are probably not as negative toward a program that does not involve large, overt government expenditures. In effect, the inefficiency of rent review in transferring assistance to those in need, may be the price society pays for its perceptual preferences for indirect transfers.

CHAPTER 7 — Redistribution

The economic and social policies of governments invariably involve a distribution of costs and benefits that varies among different groups of people. Some will be net winners from the policy in that their benefits will exceed the costs they bear. Others will be net losers. The purpose of this chapter will be to study the pattern of winners and losers arising from the operation of the rent review program in altering levels of rent. While other types of costs and benefits, as discussed in other chapters, are important, a key determinant of attitude toward rent review will be the pattern of rent savings on the one hand, and the distribution of loss of rental income on the other.

In exploring this issue, the next sections will serve to clear out some of the conceptual underbrush and data limitations. The sections following will review the empirical evidence of the impacts on households successively classified by income, age, and other groups.

Conceptual Issues

In measuring redistribution one must establish: (1) a base from which the change is measured; (2) the resulting distribution to which the base is compared; and (3) the criteria relevant to the evaluation of the change. Each of these will be taken up in turn.

In choosing the base for the comparison, a major question is whether the base can be taken as the distribution at some chosen point in time or whether the comparison should be against a distribution that can be defined as a standard. In the context of rent review, some would want to argue that the program has prevented a redistribution of income to landlords (i.e., measuring redistribution from the 1975 level, the period at the start of rent review), whereas others would compare the distribution on the basis of the difference between actual current rents and what rents would be in the absence of the program (the latter being one standard of base measure).

Several problems exist in using a base of some point in time. First, the point in time in question may be one that is particularly beneficial to one side of the issue. In labour negotiations, for example, workers may argue for the restoration of a previous peak in labour's share, whereas management may argue for restoration of the best previous management position. In that labour/management or tenant/landlord relative positions will vary over time, differences of opinion as to the proper base period are inevitable. In particular, landlords would argue that 1975 caught landlords in a disadvantageous position in view of rising costs.

A second problem, that flows from the first, is that the selection of a previous time period begs the question as to whether that chosen point in time is an appropriate standard. Thus, it can be argued that an explicit choice of a standard should be made rather than leave the result to whatever conditions prevailed at a particular point in time.

A third problem is that the choice of a specific time period would lock in the circumstances at that time for a considerable period irrespective of any changes in the related conditions since that date. In the case of rent review, this would ignore developments in inflation, interest rates, population shifts and general economic and housing market conditions. There is great danger, therefore, that such a standard would become badly outdated over time.

There are, of course, a variety of standard distributions that could be defined as a basis for measurement. An advocate of free markets would argue that the comparison should be between controlled and fully uncontrolled rental levels. In contrast, others might seek the elimination of landlord profits and the interest return to financial capital. An intermediate position would look to an orderly, phased return to market conditions.

In this Chapter, redistribution will be measured against market levels of rent. This standard is a generally accepted one for mainstream economists and policy analysts. In the final Chapter of the report, "Values and Perceptions," the social values that underlie alternative choices of standard distributions will be discussed.

The second of the three conceptual issues relating to measurement is the selection of the resulting distribution which is to be compared with the base. As in the last Chapter, the 1978 Statistics Canada Household Income Facilities and Equipment survey is taken as the empirical base. This data is then adjusted by the same rent increase used in the last chapter — 7.5 per cent in order to derive estimates for 1980. Because there is no strong evidence that rents have been altered by rent review in different amounts for different groups, equal percentage impacts are assumed.

The third conceptual measurement issue relates to the relevant criteria for evaluation of redistribution. Economists and policy analysts typically[1] distinguish two tests that are to govern any evaluation of redistribution — vertical and horizontal equity:

> "Vertical equity refers to the proper pattern of unequal benefits among persons with unequal incomes; while horizontal equity refers to equal benefits for people with equal incomes."[2]

Vertical equity usually is taken as meaning that government policy should have a progressive rather than a regressive impact — that net benefits should be transferred from rich to poor.

[1]For example G. Fallis, especially pp.47 and 48.

[2]G. Fallis, p.47.

Both vertical and horizontal equity will be explored in the section on redistribution by income class. In the succeeding sections these concepts will be adapted to the other groups defined for the measure of redistribution.

Data Issues

There are a number of limitations on data available and on the assumptions required for use in the analysis.

Some of those limitations have been mentioned in other sections of this report. Other limitations are relatively minor. Major limitations are explained below.

The Household Income Facilities and Equipment Survey excludes the very rich for reasons of maintaining confidentiality. Their exclusion will affect estimates, especially those regarding the distribution of rent savings and losses by income class. Little can be done to correct for this bias.

The effects of rent review are assumed proportional, with all renters and landlords being affected by a uniform 7.5 per cent rent reduction. While rent review may have differential impacts, no evidence exists that can support the extent of varying degrees of influence.

Impacts are assumed to be linear — that is a 10 per cent impact is 10 times the one per cent impact. This assumes that relevant behaviour (e.g., decision to be a renter) is not affected by the rent change. It also measures the first round impact of the transfer and not the final incidence after allowance for behavioural adjustments. Again, little evidence exists on such adjustments.

The benefits from rent savings are valued at the dollar amount of rent reduction and are not adjusted downward to reflect that the savings are tied to the purchase of a particular commodity (i.e., specific rental units) and not otherwise available. A direct income transfer of equal dollar amount is believed to be of greater value to the household in that the consumption mix decisions would be free from bias toward a specific commodity. The amount of any such bias is believed to be relatively minor and is ignored here for simplicity.[3]

Direct information does not exist on how much income from residential rental property in Ontario is earned by various types of households. It is known how investment income from all sources is shared, and it has been assumed here that rental income is distributed among household types in the same manner as total investment income.

[3]For full details, see John Miron, "The Redistributive Impacts of Rent Review: Empirical Findings," (for the Ministry of Municipal Affairs and Housing, 1981) pp.13-16 (mimeographed).

Distribution by Income

In Table 7.1, a summary is provided of the transfers between income groups resulting from rent reductions. This Table includes all Ontario households whether tenant, landlord, both or neither. As such, it measures vertical equity, the degree to which income is transferred between income classes. Later tables will explore the degree of horizontal equity and the qualifications to the interpretation of vertical equity that are required given the degree to which horizontal equity is violated.

From Table 7.1, it can be seen that slightly over one-half of the total benefits in the form of rent reduction went to the highest two income groups which included about three-fifths of all households, with the remaining rent reduction shared by the lower income classes. The total cost of the rent reduction is shared more heavily by the higher income groups, with slightly over half of the cost being borne by the highest income group and almost three quarters by the two highest. Almost one-quarter of the burden was, however, borne by the lowest four income classes. Looking at the net impact, it can be seen that the only income group that was a net loser from lower rents was the highest group, with gains made by all the household classes with lower incomes.

The average annual benefit per household rises with income over the first four income groups and then falls in each of the next two. It will be seen that horizontal equity considerations have much to do with this pattern. Average costs are lowest for the lowest income and highest for the highest class, but show an irregular pattern in the middle four classes. A similar irregular pattern can be noted in the average net impact.

In relation to incomes earned, benefits are more important to those with lower incomes, with the ratio of benefit to income falling with each increase in income class. The cost to income pattern is somewhat irregular, but is higher for the three lowest income groups than the higher three classes. Net impacts relative to income decline in a regular pattern with increases in income. Only in the lowest group is the net impact greater than one per cent of income.

In Table 7.2, the number of unsubsidized tenants are compared to the total number of households in each income group. Unsubsidized tenants are the group which benefits from rent review, whereas others in the income class (subsidized tenants and owners) do not.[4] The proportion of unsubsidized renters rises as one goes from the lowest to the third lowest income group, stabilizes in the fourth lowest and then falls in the two highest groups. This pattern is explained by the fact that the lowest groups can be expected to have a high proportion of subsidized tenants while the higher groups have a large proportion of owners.

[4]However, recall again the above-mentioned problem in defining subsidized renters.

Table 7.1

Summary of Benefits and Costs of Rent Reduction to all Ontario Households, 1978 by Income Groups

	Under $4,000	$4,000-7,999	$8,000-11,999	$12,000-14,999	$15,000-24,999	$25,000 or more	All Income Groups
Households (000)	235.3	292.9	280.4	271.0	909.7	772.4	2,761.7
Average Income ($)	2,440	6,050	10,010	13,560	19,650	35,240	19,526
Total Benefits ($million)	13.7	19.1	21.7	21.2	55.9	27.5	159.1
Total Cost ($million)	2.9	11.8	14.1	11.7	35.1	83.4	159.1
Total Net ($million)	10.8	7.3	7.6	9.4	20.8	- 55.9	0
Average Benefits ($)	58.17	65.14	77.53	78.08	61.51	35.60	57.61
Average Cost ($)	12.45	40.25	50.22	43.29	38.62	108.05	57.61
Average Net ($)	45.72	24.89	27.31	34.79	22.89	- 72.45	0.00
Benefit/Income (%)	2.4	1.1	0.8	0.6	0.3	0.1	0.3
Costs/Income	0.5	0.7	0.5	0.3	0.2	0.3	0.3
Net/Income	1.9	0.4	0.3	0.3	0.1	- 0.2	0.0

Note: Categories may not equal totals due to rounding

Source: J. Miron, "The Redistributive Impacts of Rent Review: Empirical Findings" based on unpublished data from Statistics Canada, 1978 Household Income Facilities and Equipment Survey (HIFE).

Table 7.2

Unsubsidized Renter Households
as a Per Cent of All Households
by Income Class, 1978

Household Income (000)	Unsubsidized Renters (000)(%)	Total Households (000)	Incidence of Unsubsidized Renters (%)
Under $4,000	80	235	33.9
$4,000- 7,999	110	293	37.6
8,000- 11,999	117	280	41.7
12,000- 14,999	112	271	41.4
15,000- 24,999	270	910	29.7
25,000 and over	113	772	14.6

Note: Number of households rounded to the nearest thousand

Source: J. Miron, "The Redistributive Impacts of Rent Review: Empirical Findings" based on unpublished data from Statistics Canada, 1978 HIFE.

Similar data for the landlord side of the benefit — cost equation is not directly available. Some evidence of relevance is, however, presented in Table 7.3. Data in this table is Canada-wide and is used for Ontario as an approximation. Owners of real estate other than own home or vacation cottage are a distinct minority in all income classes. The tendency to own other real estate does increase significantly with income, although the value of other real estate in relation to total assets increases much more slowly with income. While one must be careful to note that other real estate may include vacant land or commercial or industrial buildings and that other households may own residential rental buildings indirectly (e.g., through equity in development corporations), the conclusion that landlords are a distinct minority in all income classes seems safe.[5] Thus, the major burden of rent review falls on the minority who are landlords, while the majority of equal income escape this effect.

[5]This statement ignores, however, the ownership of rental apartments either directly or through stock ownership by pension funds. Peter Drucker has noted that over one-third of all corporate stock in the United States is owned by pension funds. See Peter Drucker, "Pension Fund Socialism" Public Interest, Winter, 1976 #42, p.1. This may mean that many more people are 'landlords' in the sense that their retirement income is negatively affected by rent review. Again, it did not prove possible to estimate this effect for Canada empirically. Indeed, given the life-long accumulation of pensions, there are considerable conceptual difficulties in interpretation of income classes involved in redistribution.

Table 7.3

Direct Investment in Real Estate
Other Than Home or Vacation Home
Canada 1977

Income Class	Per Cent of Total Assets in Other Real Estate	Per Cent Having Other Real Estate
Under $3,000	5.8	4.7
$3,000- 4,999	6.3	6.1
5,000- 6,999	5.4	7.4
7,000- 9,999	5.7	8.1
10,000-14,999	5.7	9.7
15,000-19,999	7.1	14.9
20,000-24,999	6.3	15.5
25,000-34,999	6.4	18.5
35,000 and over	7.4	27.5
All Income Classes	6.5	12.1

Source: Statistics Canada Income, Assets & Indebtedness of Families in Canada 1977, Catalogue 13-572, Tables 17 and 21.

Rent review by definition does not produce a result that provides equal benefits or costs to those of similar incomes regardless of their tenure choice or choice of investment. The standard criteria of horizontal equity is, therefore, necessarily violated by such a program considered by itself. A wider study might consider the distribution of benefits and costs over all housing programs and so include low income government subsidies and ownership tax benefits in the balance. Such a study is well beyond the scope of this analysis. It is useful, however, to view the results of the horizontal inequity on the vertical equity.

In Table 7.4, the impact of rent reductions is presented for only those actually benefiting from rent review — the unsubsidized renters. Because they may also be landlords of other tenants, either directly or through stock ownership, the group may also bear some of the costs of the program transfers. Indeed, if their investment income is distributed according to the same assumption as used for all investors, these renters bear almost one-quarter of the total program cost. Nevertheless, this group as a whole has a substantial net gain from rent reductions.

The average annual benefit shows a clear pattern of increase with income. This is because richer tenants tend to rent more expensive units and thereby have a larger gain in dollar amount. The average tenant in the highest income group gets a rent savings of slightly over 40 per cent more than the average for the lowest income group. This is an inevitable result of any program whose benefits increase with rent level.

Table 7.4

Summary of Benefits and Costs of Rent Reduction to Unsubsidized Renter Households, 1978 by Income Groups

	Income Groups						
	Under $4,000	$4,000–7,999	$8,000–11,999	$12,000–14,999	$15,000–24,999	$25,000 or more	All Income Groups
Households (000)	80	110	117	112	270	113	802
Average Income ($)	2,249	6,108	10,027	13,523	19,250	33,761	15,644
Total Benefits ($million)	13.7	19.1	21.7	21.2	55.9	27.5	159.1
Total Cost ($million)	0.8	3.1	3.5	4.1	11.5	15.3	38.3
Total Net ($million)	12.9	16.0	18.2	17.1	44.4	12.2	120.8
Average Benefits ($)	171.38	173.03	186.05	188.75	207.34	243.92	198.48
Average Cost ($)	9.50	28.22	29.80	36.41	42.77	136.00	47.79
Average Net ($)	161.88	144.81	156.25	152.34	164.57	107.92	150.69
Benefit/Income (%)	7.6	2.8	1.9	1.4	1.1	0.7	1.3
Costs/Income (%)	0.4	0.5	0.3	0.3	0.2	0.4	0.3
Net/Income (%)	7.2	2.4	1.6	1.1	0.9	0.3	1.0

Note: Categories may not balance due to rounding

Source: Based on unpublished data from Statistics Canada, 1978 HIFE.

The tendency for the amount of benefit to increase with income is offset to an extent by the pattern of average costs related to the 'landlord' investments of these tenants which increases strongly with income. The net impact on average is for an uneven pattern for the lowest five income groups and a drop in net result for the highest group.

As a proportion of income, both benefit and net impact are greatest for the low income group and fall with increasing income. Cost burden in relation to income shows no regular pattern.

No attempt was made to isolate landlords as a group for similar analysis. The assumptions required for such an effort are daunting. However, one can say that the average cost to landlords would be very much higher than that indicated for all households in Table 7.1 and the cost to income ratio would also be much higher.

What then can one conclude regarding the redistributive effects of rent reduction among income groups?

In favour of rent review as a redistributive tool are the following points:

(1) about 1/3 to 2/5 of households with low and moderate incomes benefit from the program, while a smaller per cent of higher income groups benefit;

(2) benefits and net transfers are a higher share of income for lower income classes;

(3) about 3/4 of the cost in terms of rent reduction is borne by the top 60 per cent of households in term of income distribution.

Against use of rent review as an income transfer device:

(1) over one-half of the total benefit goes to the two richest household groups;

(2) among renters the average benefit tends to increase with income;

(3) the cost of the redistribution is borne by a small proportion of the population implying substantial costs for landlords and no direct cost to other people with equal income levels.

Distribution by Age

The age profile of households who gain or lose as a result of rent reductions is presented in Tables 7.5 and 7.6. In Table 7.5, there is a clear pattern of net transfer with the younger age groups gaining at the expense of older groups. Indeed, the largest winners are under 30 years of age and the biggest losers are at near-retirement or in the retirement age groups. Thus, while rent review works to the advantage of newly formed households, it imposes almost 60 per cent of its cost on those who are 55 and over.

In Table 7.6, it can be seen that the pattern of benefits from the previous table was largely due to the greater propensity to rent among the younger age groups and that average benefits are not strongly related to age differences. The surprising result, that those renters 65 and over are net losers from the program, reflects a mixture of all renters who gain and a minority of elderly renters who have direct and indirect investments in residential rental buildings. Nevertheless, it draws attention again to the fact that if rent review is seen as a program that protects elderly renters, it is also a program with a negative impact on the retirement savings of a substantial number of elderly people.[6]

[6]Note that any losses arising through losses suffered by pension funds would most directly impact on the elderly.

Table 7.5

Summary of Benefits and Costs of Rent Reduction to all Ontario Households, 1978 by Age Groups

	Age Groups								
	Under 25	25–29	30–34	35–39	40–44	45–49	50–54	55–64	over 65
Households (000)	201.5	339.6	337.8	277.5	261.2	256.3	261.3	405.8	420.7
Average Income ($)	14,370	18,510	20,210	22,590	24,180	25,980	23,620	20,090	10,330
Total Benefits ($million)	29.2	33.3	25.6	11.2	9.3	7.4	8.6	16.1	18.4
Total Costs ($million)	4.2	4.4	6.1	9.3	11.0	16.8	16.3	34.0	57.0
Total Net ($million)	25.0	28.9	19.5	1.9	-1.7	-9.4	-7.7	-17.9	-38.6
Average Benefits ($)	144.98	98.10	75.92	40.23	35.55	28.87	32.81	39.70	43.75
Average Costs ($)	20.91	13.08	18.08	33.38	42.32	65.43	62.48	83.67	135.47
Average Net ($)	124.07	85.02	57.84	6.85	-6.77	-36.56	-29.67	-43.97	-91.72
Benefit/Income (%)	1.0	0.5	0.4	0.2	0.1	0.1	0.1	0.2	0.4
Cost/Income (%)	0.1	0.1	0.1	0.1	0.2	0.3	0.3	0.4	1.3
Net/Income (%)	0.9	0.5	0.3	0.0	0.0	-0.1	-0.1	-0.2	-0.9

Note: Categories may not balance due to rounding

Source: J. Miron, "The Redistributive Impacts of Rent Review: Empirical Findings" based on unpublished data from Statistics Canada, 1978 HIFE.

Table 7.6

Summary of Benefits and Costs of Rent Reduction to Unsubsidized Renter Households, 1978 by Age Groups

	Age Groups								
	Under 25	25–29	30–34	35–39	40–44	45–49	50–54	55–64	over 65
Households (000)	201.5	339.6	337.8	277.5	261.2	256.3	261.3	405.8	420.7
Unsubsidized Renters (000)	157	168	124	55	46	38	42	80	92
Incidence (%)	77.9	49.5	36.7	19.8	17.6	14.8	16.1	19.7	21.9
Average Income Unsubsidized Renters ($)	13,617	16,321	16,783	17,825	17,588	19,352	18,593	15,442	11,354
Average Benefits ($)	186.41	198.26	206.12	202.85	201.17	196.06	205.28	201.83	200.12
Average Costs ($)	20.46	11.65	15.69	22.38	20.32	45.56	56.15	78.51	203.15
Average Net ($)	165.95	186.61	190.43	180.47	180.85	150.50	149.13	123.32	-3.03
Net/Income (%)	1.2	1.1	1.1	1.0	1.0	0.8	0.8	0.8	0.0

Source: Based on unpublished data from Statistics Canada, 1978 HIFE.

Distribution — Other Groups

Further information on the distribution of gains and losses is presented in Table 7.7. Benefits in rent savings going to families with children total some $55.6 million while the savings of childless individuals and couples under the age of 65 total $85.7 million. The largest net transfers in relation to income go to childless individuals and couples below the age of 35. One may conclude that rent review is not a program targeted to families with children.

Another focus could be on homeowners or subsidized renters. People in these groups are affected by rent reductions in the controlled sector to the extent that they are landlords. The aggregate loss of these two groups is equal to that of the net gain of renters in Tables 7.4 and 7.6 About three-fourths of the total losses are borne by homeowners who are landlords, almost one-fourth by unsubsidized tenants and a very small share by subsidized tenants.

Table 7.7

Summary of Benefits and Costs of Rent Reduction by Household Type
All Ontario Households, 1978

	One Person			Two Person, Childless			Children 2 Parent		Children One Parent
	Under 35 yrs.	35—64	65 or Older	Under 35 yrs.	35—64	65 or Older	Youngest Under 6	Youngest 6 or Older	All Ages
Households (000)	145.6	175.9	165.9	236.5	322.8	227.5	515.7	769.9	202
Average Income ($)	11,320	11,410	5,050	21,290	21,490	13,100	20,930	27,050	14,170
Total Benefit ($M)	23.3	15.6	8.1	32.4	14.4	9.6	22.2	17.8	15.6
Total Cost ($M)	3.0	9.9	14.7	5.2	21.6	39.6	11.2	47.1	6.7
Total Net ($M)	20.3	5.7	-6.6	27.2	-7.2	-30.0	11.0	-29.3	8.9
Average Benefit ($)	160.25	88.65	49.09	136.82	44.73	42.41	43.01	23.09	77.44
Average Cost ($)	20.45	56.40	88.84	21.81	66.94	174.29	21.75	61.18	33.45
Average Net ($)	139.80	32.25	-39.75	115.01	-22.21	-131.88	21.26	-38.09	43.99
Net/Income (%)	1.2	0.3	-0.8	0.5	-0.1	-1.0	0.1	0.1	0.3
Unsubsidized Renters									
Households (000)	129.9	86.6	44.0	154.6	69.9	44.9	114.3	79.7	77.8
Incidence (%)	89.2	49.2	26.5	65.4	21.6	19.7	22.2	10.3	38.5
Average Benefit ($)	176.65	179.98	185.17	209.29	206.67	214.67	194.08	223.19	201.00

Source: J. Miron, "The Redistributive Impacts of Rent Review: Empirical Findings" based on unpublished data from Statistics Canada, 1978 HIFE.

CHAPTER 8 - Security of Tenure

No discussion of rent review would be complete without consideration being given to the related concept of security of tenure. The right of a tenant to continue occupancy of a particular rental unit is widely regarded as being indissolubly linked to the existence of rent review. This Chapter will examine this relationship, will note the growth in security of tenure in Ontario over the past 12 years, will examine the concerns that security of tenure raises for landlords and the concerns that tenants relate to this issue, and will end with a consideration of the alternative directions that may be taken in terms of ensuring a continuation of adequate security of tenure.

The Link Between Security of Tenure and Rent Review

It has been argued that security of tenure will only be effective where control on rent exists and that control over rents will only be assured in cases where tenants have security of tenure. That is, you can't have one without the other.

The first half of the argument relates to the concept of economic eviction. An economic eviction occurs when a tenant is forced out of the rental unit as a result of being faced with large increase in rents beyond the fair market value for the unit. In such circumstances, security of tenure may mean little in that while landlords may still be required to establish adequate cause in court in order to obtain an eviction order, the landlord may choose to use rent increases to obtain the same end result, and may do so even where adequate cause for eviction could not be proven. Hence, the need for controls is argued to ensure adequate security of tenure.

The second half of the argument relates to the concept of retaliatory eviction. A retaliatory eviction occurs whenever a landlord evicts a tenant because of the tenant's exercise of legal rights. If rent controls existed without security of tenure, landlords might penalize tenants who enforced their right to rent review by evicting the tenants. Even with a special prohibition on retaliatory eviction, adequate security may not exist. As has been pointed out by the Law Reform Commission of British Columbia: "Retaliatory eviction may be particularly difficult to prove where it is open to a landlord to terminate a tenancy for any other reason whatever."[1] As a result of experience arising from this kind of consideration Mr. Justice Wishart Spence has observed: "security of tenure is absolutely necessary for the enforcement of control of the price; experience has shown that so soon as security of tenure is let go, control of price disappears."[2]

[1]Law Reform Commission of British Columbia, Report on Landlord and Tenant Relationships: Residential Tenancies, (British Columbia: Department of the Attorney General, 1973) p.63.

[2]Justice Wishart Spence, Rent Controls in Canada (Law Society of Upper Canada, Refresher Course Lectures, Vol.1, 1945) p.295.

In the final Section of this Chapter, "Alternative Directions for Security of Tenure," it will be necessary to test whether there are any measures that can change the interrelation of rent controls and security of tenure. Before doing so, however, it is necessary to understand the recent historical development of security of tenure, as well as the basis for landlord and tenant views on the subject.

Recent Developments in Security of Tenure

Prior to 1970, tenants in Ontario had no security of tenure beyond that covered in their lease agreement. Indeed, the rights of tenants were generally inadequate. As J.B. Cullingworth notes:

> "For example, a tenant had to continue paying rent on a house which was completely destroyed by fire. ... Furthermore, to use legal language, covenants were presumed to be independent. Thus a breach of the landlord's covenant (e.g., to provide heating) did not relieve the tenant of his obligations including the obligation to pay rent."[3]

The reason for this state of affairs can be traced historically:

> "This classic reason ascribed for this unhappy state of affairs is that a lease creates more than a contract. It creates an estate in land. The argument proceeds that since the estate remains vested in the tenant, the land remains available to him even though the buildings have been totally destroyed. The lease does not cease merely because it has become burdensome or, indeed, because performance of one or more of the contractual obligations has become impossible.[4] Though historically defensible, this view of the matter, particularly with reference to residential tenancies, is outmoded and unacceptable."[5]

[3]J. Barry Cullingworth "Security of Tenure: A Report to the Ministry of Housing" (for the Ministry of Municipal Affairs and Housing, 1981) p.1 (mimeographed).

[4]Reference is made to Cheshire's The Modern Law of Real Property, 9th edition, 1962, p.396.

[5]Interim Report of the Ontario Law Reform Commission on Landlord and Tenant Law Applicable to Residential Tenancies (Ontario: Department of the Attorney General, 1968) p.54.

The revisions to The Landlord and Tenant Act which came into effect in 1970 started to redress the balance. It provided for the first time a separate legal framework to govern residential tenancies. It dropped the presumption that covenants were independent and introduced the first changes regarding security of tenure. Landlords now could regain possession only under authority of a court writ of possession pursuant to a court order to evict. Furthermore, the court could refuse an eviction order on the grounds that the landlord was in breach of his obligations, where the tenant had complained to any governmental authority regarding health, safety or housing standard violations or where the tenant had attempted to enforce his legal rights.

While these changes improved tenants' security of tenure, the major revision on the issue occurred with the 1975 revision to The Landlord and Tenant Act. These revisions were introduced to take effect at the same time as The Residential Premises Rent Review Act and were introduced in part in order to permit effective controls. Under the revisions to The Landlord and Tenant Act, landlords wishing to terminate tenancies are required to have one of the causes for termination that is specified in the law and a judge may only issue a writ of possession to evict a tenant if the landlord can prove the reason for termination.

With the passage of the 1975 legislation a very large shift in the balance between landlords and tenants had occurred relative to only a few years ago. In large part, landlords have come to accept these new tenant rights to security of tenure. What landlords have found difficult to accept are the delays inherent in the present system. As was explained in the Green Paper, Policy Options for Continuing Tenant Protection:

Under the existing Act, if a landlord seeks to terminate the tenancy for failure by the tenant to pay rent, the following rules apply:

- the landlord must give notice of termination, in appropriate form, of the tenant's failure to pay rent and specify a date for termination not less than 20 days after notice is given;

- the landlord must then wait 14 days during which the tenant has the right to pay the rent and invalidate the notice;

- if the rent is not paid, the landlord is entitled to apply to the court. The landlord must serve the application on the tenant, giving at least four days notice of the appointment before the county court clerk. As the clerks of the court in the urban areas are overburdened with applications, appointments often cannot be made for several weeks;

- the tenant need only appear in person before the clerk on the appointed date to dispute orally the termination for the matter to be put over to the county judge. The tenant may also file a written dispute;

- if the tenant, at any time prior to the judgement becoming final, pays into court the arrears and the cost of the application to the court, the proceedings end;

even when the judgement is obtained, if the tenant has not left voluntarily the landlord must wait, usually several weeks, before the sheriff's office has time to perform the eviction.

The landlord, who may have a judgement for both the arrears of rent and compensation for the period the tenant has been over-holding, is often faced with an impecunious tenant and must wait for payment or abandon all hope of recovery.

For the small landlord faced with burdensome mortgage payments, such non-payment can be financially disastrous. The cost of keeping a non-paying tenant in possession is high for all landlords and is ultimately passed on to the paying tenants. Thus, the burden of those who cannot, or will not, pay rent is borne by landlords and paying tenants. It would appear inequitable that they should support this burden. A simplified more expeditious procedure for dealing with rent arrears and evictions appears desirable.[6]

Nor could the delays and formalities of proceeding through the court system be judged uniformly favourable to tenants. In questions relating to the enforcement of landlord obligations, clearly tenants will want expeditious decisions. Even in cases of potential eviction, tenants may wish to minimize the period of uncertainty, in that a worried tenant may well decide to arrange a move prior to the final decision which might have justified continued tenure. Finally, in other jurisdictions, it has been argued that the courts may have a tendency to favour landlord positions because of a number of sociological factors.[7]

Given these problems, legislation, in the form of The Residential Tenancies Act, was introduced to reduce the delays in dealing with landlord and tenant disputes, reduce the formalities from those involved in the court administered system, and provide for a convenient consolidation of functions relating to rent review, landlord and tenant relations and the provision of information and advice.

This Act was passed in 1979, but the Sections of the Act that were to replace Part IV The Landlord and Tenant Act (dealing with residential tenancies) were not proclaimed pending court ruling on the constitutionality of a number of provisions relating to evictions and the power to issue compliance orders under the Act. On May 28, 1981, the Supreme Court of Canada ruled that the Province did not have the constitutional authority to set up a Commission to handle these functions. Accordingly The Landlord and Tenant Act continues to govern security of tenure.

[6]Ministry of Consumer and Commercial Relations, Policy Options for Continuing Tenant Protection (Toronto: Ministry of Consumer and Commercial Relations, 1978) p.47.

[7]See J.B.Cullingworth, "Security of Tenure," pp. 72-76 and works cited therein.

Given this brief historical background, it is appropriate to consider both landlord and tenant views on any changes to existing security of tenure.

Landlord Concerns - The Definition of Property Rights

It should be clear that changes to security of tenure are, in essence, changes to the property rights of landlords and tenants. For example, during the terms of the lease, the property becomes the possession of the tenant. Moreover, under existing legislation, at the end of that term, unless the property owner has a legally valid reason for wishing repossession and complies with the appropriate legal procedure established in law, the tenant can remain in possession of the property for however long the tenant wishes - all assuming, of course, that the tenant continues to meet his obligations. The tenant does not have the right to dispose of the property, but can have the use of it indefinitely. Thus the 1975 legislation involves a substantial transfer of property rights from landlords to tenants.

It may be useful to reflect on the implications to landlords and indirectly on tenants of the limits being placed on property rights of landlords:

> "Landlords argue that the rented premises are the property of the landlord and that he should have the right of a property owner to decide who should be entitled to live in his property. Further, the landlord is the one who is at risk if the property is not properly cared for; his capital tied up in it will be lost if the property deteriorates. The property is his source of income and it would be unfair to take away his power to choose tenants who will best look after the property and ensure his continued income..... Security of tenure is not in the long term interest of tenants generally because it will curtail the construction of new rental accommodation and hasten the conversion of existing rental accommodation to other forms of ownership. It will do that for two reasons. One is that, to the extent that it interferes with sound business decisions or causes increased expenses which cannot be recovered by rent, it will interfere with revenues and profits and cause capital to move into other forms of investment. The second is that at least some landlords and potential landlords will perceive security of tenure as a limitation on their property rights and will regard the extra trouble and friction necessary to achieve eviction as the last straw which will drive them into another form of investment, even if their financial return is not affected.
>
> "Landlords say that they will suffer loss from security of tenure because of the difficulty of evicting bad tenants and that, unless competitive conditions force them to

absorb the loss themselves, they will pass it on in the form of higher rents to other tenants who will therefore pay the cost imposed by the bad tenants. They argue that security of tenure will protect the tenant who carries on illegal activity or disrupts the lives of other tenants around him; that the landlord will not be able to evict him unless and until he can collect the evidence necessary to satisfy a court of law that there is cause for termination of the tenancy. They say that proposals for security of tenure take into consideration only bad and arbitrary landlords (who are in the small minority) and if adopted such a proposal would prevent a conscientious landlord from protecting his good tenants from harassment by a bad one. They say also that security of tenure would be unfair because it would be one-sided; the tenant could terminate the tenancy, but the landlord could not; if both parties want a long tenancy they can agree on one....

"It can also be argued that security of tenure will tend to cause landlords to be increasingly selective, and therefore to make it more difficult for would-be tenants who have not established credit records, young people without reference from previous landlords, and people with low incomes, to find good rental accommodation."[8]

Given that there is an impact on landlord property rights arising from redefinition of security of tenure, the question should be addressed as to the extent to which property rights should be limited.

One approach to the issue may be reflected in the provision of the Constitution of the United States prohibiting the taking of property without compensation.[9] Legal arguments have been advanced in support of the position that security of tenure and rent control legislation may be a violation of the American landlord's constitutional right to property.[10] While these constitutional arguments would not be applicable within the framework of the Canadian constitution, the legal philosophy involved is still of interest.

[8]Institute of Law Research and Reform, Report 22, Residential Tenancies (Institute of Law Research and Reform, University of Alberta, 1977) pp. 131-134.

[9]The Fifth Amendment to the Constitution of the United States of America states: "nor shall private property be taken for public use without just compensation."

[10]See J.B.Cullingworth, "Security of Tenure," pp.65-67 and works cited therein.

Chief Justice Tauro of the Supreme Court of Massachusetts in a dissenting opinion, in a case involving eviction for the purpose of renovating a unit:

> "apparently took the position that, when eviction controls operate to deprive the landlord of any alternative use of his property for an indefinite period of time, the application of such controls constitutes a taking."[11]

In addition, with regard to rent review it has been argued:

> "The Rent Control Law is unconstitutional for a reason which does not seem to have been considered in the decisions thus far - namely that it constitutes the taking of the property of one individual and the giving it to another with no compensation from any source. Admittedly some of the value is left in the possession of the owner, but in many cases the part left to the owner has only been a net loss."[12]

In a Canadian context, concern has been expressed that rent review and security of tenure have led to further erosions in property rights. Both restrictions on conversion to condominium use and on demolition can be seen in this light. Thus, many municipalities have introduced controls on condominium conversion in the past few years and the City of Toronto has been seeking additional powers to prevent the conversion of rental apartments to other uses.[13]

In sharp contrast to these views of private property rights, is the attitude expressed by former British Labour Prime Minister Harold Wilson: "The plain fact is that rental housing is not a proper field for private profit."[14] An even more revealing statement of this view is contained in the statement by Chester Hartman to the effect that:

> "The value of rent control, apart from the progressive income transfers it effectuates, is that it is an immediate gut issue around which people can organize. As they work to improve their own housing conditions, their

[11]As reported by G.A. Joseph in "De Novo Review of Local Rent Control Decisions to Evict for Renovation," Boston University Law Review, 55 (1975): 442, f.n.36.

[12]E.B. Hilley, "Rent Control - A Menace to Freedom," Georgia Bar Journal, 12 (1949): 153-160.

[13]See discussion in Smith and Tomlinson, pp. 25-26.

[14]Cited in J.B. Cullingworth, Essays on Housing Policy, (London: Allen and Unwin, 1979) p.61.

> consciousness is raised about the workings of the housing system; the demands they make on the system as a whole are sharpened. As tenant activists in New York City and elsewhere now see, the issues transcend the individual evil landlord."[15]

It is apparent that disputes over the proper definition of property rights lies at the very core of the debate over both security of tenure and rent review. As a result the debate must turn, in large part, on the view society forms as to the legitimacy of private ownership in the provision of rental housing. In doing so the full implications of such a decision must be faced.

Tenant Concerns - Protection and Choice

If landlords are concerned about continued erosion of their property rights under the combination of security of tenure and rent review, tenants are equally concerned about the prospect of eviction, including economic eviction.

Any tenant forced to leave a rental unit will incur a number of costs.[16] One cost may be the renting of a truck or van and possibly helpers, who may be paid in money or kind. Another cost will be the search cost involved in finding a new apartment, which can be measured in money and, especially, time. This search cost is likely to be much higher when vacancy rates are low. A third cost may derive from the unique features of a unit that can not be found elsewhere. Finally, there are social ties that may be disrupted, including those related to children being moved to different schools.[17] As a result, landlords could charge a premium to existing tenants who would choose to pay the surcharge rather than move. The size of the surcharge could be quite high in some cases - e.g., an invalid elderly person.

It cannot be concluded that landlords will, in an uncontrolled situation, charge existing tenants larger increases than new tenants. One reason is that costs are incurred by landlords on turnover. One cost is possible loss of rent on a vacant unit. Other costs will be those associated with redecorating, advertising and showing the vacant apartment. Finally landlords can be expected to want to retain good tenants rather than take the risk of getting a new tenant who may cause problems of one sort or another. With the exception of the last cost, these costs should be lower in tight vacancy situations. These costs may well offset any tendency of landlords to charge existing tenants more than new tenants. Indeed, the rent surveys in 1979 and 1980 did not display any

[15]Chester Hartman, "The Big Squeeze," Politics Today May - June, 1978.

[16]Discussion based in part on Richard Arnott, pp. 26, 27, 32.

[17]On the last two points see Law Reform Commission of British Columbia, pp.62-63.

general strong systematic differences between median increases charged to movers vs. non-movers.[18]

Although both tenants and landlords will in general prefer to avoid turnover, individual cases will certainly exist when they are not in agreement. Security of tenure provisions will serve the purpose of protecting tenants from the costs associated with eviction. By the same token, it increases the cost to the landlord in obtaining termination.

But clearly there is something more to security of tenure than the rational and dispassionate calculation of the direct and indirect costs of moving. Something is missing from the calculations of economists whose

> "...writings start and finish with the assumption that one house is the same as another of a similar size. This view ignores the sense of attachment which any occupier develops for his own particular piece of territory. Under private conditions the eviction of one man by another is a matter of physical strength and, all animals, including man, are capable of the ultimate absurdity of sacrificing their lives in defence of a piece of land. In a modern society the trial of strength is conducted through the pricing mechanism and the richer bid away property from the poorer. We have no reason to think that the defeated and dispossessed feel that this form of contest is any 'fairer' than a shooting match."[19]

Some of the intensity of landlord-tenant relations may indeed stem from some form of territorial imperative. One may add that this motive may not be entirely lacking from a landlord view as well.

It may also be noted that the concern felt by tenants may not be greatly allayed by the knowledge that evictions have a low probability of occurring in most tenancies. Even if 99 or 98 per cent of all tenancies were without major problems, a tenant may be greatly worried about the potential of winding up in the 1 or 2 per cent of problem cases.[20] Thus, many more than 1 or 2 per cent of tenants will be sensitive to security of tenure issues.

[18]Ministry of Housing, Rental Market Survey 1979 (Ontario: Ministry of Housing, 1979); Rental Market Survey 1980, Table 1-11 in both editions.

[19]A.A. Nevitt, The Nature of Rent Controlling Legislation in the U.K., (Centre for Environmental Studies, 1970) pp.9-10.

[20]In 1976, the number of cases of all kinds dealt with by the Ontario court system was equal to 0.7 percent of the number of rental units. Policy Options for Continuing Tenant Protection, p.27.

Finally, in considering tenant views on security of tenure, one should consider as well the concept of security of choice. While security of tenure relates to the ability to retain occupancy of the unit one is currently in, security of choice relates to the ability to move into another unit whenever one wants to improve housing conditions, escape unruly neighbours, move closer to work or rid oneself of an unpleasant landlord. If security of tenure and rent review serve to reduce the ability to move, then security of choice would be diminished and this would be an offset to the advantages of these programs to tenants. In Ontario to date, mobility rates are still fairly high - 29 per cent in Toronto moved in the last year according to the October 1981 Rental Market Survey.[21] While this rate has fallen from the 41 per cent of 1977, security of choice has not yet been seriously undermined by changes in landlord and tenant law.

Alternative Directions for Security of Tenure

With the Supreme Court of Canada's rejection of the Ontario case for the use of the Residential Tenancy Commission for the resolution of landlord and tenant disputes, there would appear to be four options open. First, the current Landlord and Tenant Act could continue to be the legislation governing security of tenure. Second, The Landlord and Tenant Act could be amended to reflect the substantive changes of The Residential Tenancies Act but retain the procedural provisions and use of the court system provided in The Landlord and Tenant Act. Third, Ontario could press for constitutional amendments that would enable it to implement the full range of changes of The Residential Tenancies Act. Fourth, the Commission could be given a role in the mediation or arbitration of disputes on consent, a role that is within current constitutional limits.

While these choices are of great importance, it would go considerably beyond the limits of this study to attempt to provide a proper evaluation of these alternatives. Accordingly, here it will be assumed that, however administered, the basic commitment to security of tenure will continue. The focus here will be on the implications of changes to rent review for security of tenure and to the definition of property rights.

Should rent review remain unaltered, or should its application become more severe from a landlord viewpoint, the tenant's security of tenure protection will remain basically unaltered. It may be true that a greater recourse to legal protection might be required if financial pressure on landlords leads to a deterioration in relations between landlords and tenants. But actual security of tenure will be fully protected by the legal system in place.

Should rent review be changed so as to lessen its impact on landlords, questions do arise as to how the rights of tenants to continued tenure can be assured. In doing this, it is necessary to separate out those impacts related to general increases in rents or on those especially

[21] Ministry of Municipal Affairs and Housing, Rental Market Survey 1981 (Ontario: Ministry of Municipal Affairs and Housing, 1981).

vulnerable to affordability problems from those in which landlords attempt to evict a particular tenant by means of an unconscionably high increase. The issue of general high rent increases can be handled by means of a supply policy, which produces an adequate level of vacancy to effectively limit rent increases, or by rent review. Affordability problems can be addressed by housing or income assistance focused to the area of need. Neither general rent increases nor affordability problems can be effectively addressed by enacting additional safeguards to security of tenure.

Four general methods of approach to providing continued security of tenure will be explored in the context of changes to rent review. This returns to the question of whether security of tenure and rent review are indissolubly linked.

First, relaxation of rent review could proceed on a voluntary unit-by-unit basis. One way to do this would be to release units from controls as they become vacant. A concern here will be with the temptation of landlords to induce vacancies through harassment. This could be handled by requiring landlords to get a signed statement from tenants as to the voluntary nature of the vacancy in order to be decontrolled. But this could still result in a number of problems - including intimidation, tenants that would refuse to sign even where their departure was voluntary, and the fact that future tenants' security of tenure would not be assured. This last problem might be addressed by having units decontrolled for only the first rent charged the next tenant, with subsequent rent increases controlled. A final variant on voluntary decontrol is one in which landlords can buy decontrolled status on a unit from their tenant. This method is practised in Hong Kong. Arnott does not believe, however, that this method would be applicable to Ontario:

> Contracting out is not, in our view, a viable option. It has been employed in Hong Kong, but the modus operandi of business in that part of the world is very different from that in Ontario. Hong Kong has no convention of fixed prices; rather, people normally bargain over everything. In such a society it is perfectly reasonable for a landlord and a tenant to bargain over how much the former is to pay the latter if he vacates. However, such a procedure would be quite alien to our way of doing business. It would also waste a great deal of time and effort. If contracting out were applied in Ontario, it might develop into a fixed price system in which the landlord would quote both a rent and a price that he would pay to anyone who vacated. Even if such a system did develop, it would not be desirable. In our view, controls hurt landlords unjustly. The contracting-out method of decontrol would add insult to injury.[22]

[22] Arnott, p.116.

Second, a system of collective bargaining could replace rent review. This would protect any individual from arbitrary economic eviction in that landlords would have to bargain with tenants as a group in establishing rents. There is an inherent problem in using this approach. In a labour negotiation workers lose their wages during a strike, while the owners of the firm lose the value of the output. In a tenant rent strike, landlords do not collect rents, but tenants continue to have use of the units. Thus, there is an imbalance in the pressure to settle. Such an imbalance manifested itself in the Swedish experience with tenant bargaining in place of government controls. As Sven Rydenfelt explains:

> "A conflict with extended rent strikes would very soon have created a financial catastrophe for the landlords, ... A blackmail situation developed, and the new government had to pay the ransom - one billion crowns to the local authorities - bridging the gap between the rents they urgently needed and the rents the tenants were willing to pay ... the new negotiation system, founded on self-supporting rents, was in ruins after a few years."[23]

Third, specific provision can be made for cases of unconscionable rent increases. Such a provision might prevent economic evictions.[24] Two methods of operation would be:

- the landlord could be required to establish that his or her rents are in line with rents on similar accommodation when an increase was questioned as being unconscionable;

- the use of an excessive rent increase as a means of eviction might be limited by a requirement that the unit would have to be rented to a subsequent tenant at close to the same rent as demanded of the former tenant (unless an unreasonable period of vacancy occurs) and that the former tenant have a right to a punitive award up to the difference between the rent demanded of him or her and that charged the subsequent tenant.[25]

[23]Sven Rydenfelt, "The Rise, Fall and Revival of Swedish Rent Control," in W. Block and E. Olsen eds. Rent Control: Myths and Realities (Vancouver: Fraser Institute, 1980) pp. 222-223.

[24]Policy Options for Continued Tenant Protection, p.34.

[25]Policy Options for Continued Tenant Protection, p.45.

Fourth, the existing rent review structure could be changed to one of fixed point arbitration. Landlords could set any rent they wished but tenants would be able to appeal any amount as an excessive increase. The appeal would be determined either in favour of the landlord's increase or the tenants counter-proposal — but no other figure. Under such an approach a landlord would be unlikely to gain a favourable decision where the rent increase was out of line with market realities and economic evictions would be prevented. The potential problems of such an approach would relate to a question of how the Commission should decide between the two rents: on the basis of cost, rate of return, comparable rents or some other criteria. Each of these alternatives would, in turn, have an impact on housing markets which should be subjected to further analysis.

CHAPTER 9 — Values and Perceptions

In the last three Chapters, three of the most important criteria in support of rent review have been examined. Yet, there is more to the popular support for rent review than its perceived ability to solve affordability problems, its degree of contribution toward a desirable income redistribution or its role in ensuring security of tenure. There are also important subjective elements. One of these subjective elements is the question of fairness or justice that is associated with how rents are determined. Another is the psychological attitude toward rent increases in the current inflationary environment. Such criteria are more difficult to define or measure than the other issues, but they are important enough to warrant consideration.

Rent Review and its Critics

The current rent review system provides for three basic methods of determining rent increases on units covered by review:

(a) for units not going to a rent review hearing, the maximum allowable increase is set at 6 per cent;

(b) for buildings going to a rent review hearing on a landlord application, the rent increase must be justified by increased costs, provision is made to remove financial losses and allow up to 2 per cent return over cost, variations in standards of maintenance and repairs may lead to adjustment;

(c) on tenant appeals, decisions are made on the basis of comparable rents in the building or area and variations in the level of maintenance and repairs.

These mechanisms of rent determination have been subject to a number of criticisms.

On one side, there are those who criticize the current system for allowing too much in the way of rent increases. The 6 per cent allowable increase has been questioned on the ground that actual cost increases may be lower:

> "By preventing tenants from appealing any increases that are below 6%, numerous landlords will be able to effect unjustifiable increases that are in no way related to their own higher costs."[1]

[1]Community and Legal Aid Services Program, "Submissions Regarding Bill 163, Exhibit 185, Standing General Government Committee," (Toronto: Osgoode Hall Law School, April 3, 1979) pp. 3-4. Note: tenants can appeal increases below 6% — it is just that cost pass-through is not used.

The 2 per cent relief of hardship provision has also been opposed:

> "Not only has the Bill not tightened the provisions regarding such financial loss, but .... it now allows an additional 2% increase to be awarded above the break-even point. At the very least the provisions for an additional 2% increase should be deleted."[2]

These statements and others seem to indicate a view that landlords should receive rent increases that are no more than what is necessary to cover increased costs. Some go farther and recommend that certain costs not be allowed:

> "We recommend that financing costs be completely removed from the cost pass-through system and only increased operation costs be passed on.
>
> "We recommend that the onus be on the landlord to not only prove that he spent the money but also that it was absolutely necessary, for any amount exceeding that spent on the same item for a similar building."[3]

On the other side the existence of rent review has been seen as an attack on the viability of a private rental sector:

> "In conclusion we would like to say once more that we believe Rent Review to be an outrageous political red herring which is destroying a vital and necessary sector of our economy."[4]

The role of the private sector is also seen as the solution to current problems:

[2]Parkdale Community Legal Services, "Submissions Regarding Bill 163, Exhibit 55, Standing Social Development Committee," (Toronto: Parkdale Community Legal Services, December 4, 1978) p. 33.

[3]Tenant Hotline, "Brief to the Standing General Government Committee of the Ontario Legislature," (Ontario: Tenant Hotline, May 31, 1978) pp. 3 and 4.

[4]Multiple Dwelling Standards Association, "Brief to the Standing Social Development Committee," (Toronto: Multiple Dwelling Standards Association, November 22, 1978) p.6.

> "It is also historically self-evident that building deterioration and lack of building will be reversed once the free market is allowed to prevail."[5]

Clearly these diverse viewpoints, in part, result from differences of opinion related to the objective measures presented in previous Chapters. But, just as surely, they also relate to differences in values of the participants.

Three Value Systems

In light of the previous policy debate, there would seem to be three basic systems of values that are used to define the appropriate direction for rent review policy.

One of these approaches may be termed the 'cost-only' approach. Under this approach, rents should be determined by costs and not by any other considerations. In the extreme form of this view, rent levels should be equal to cost levels with no profit being earned. In this form, housing would be treated as a public utility. In the incremental form, changes in rents should be equal to changes in costs, with profit levels being frozen at existing levels. A constant level of profits is worth less over time as inflation eats away at the value of the fixed level of profits.

The second view may be referred to as the 'free market' approach. This approach would have rent levels set in the market place as a result of the agreements made by individual landlords and tenants free from government intervention of any kind. Profits in this view are to be unrestricted by controls and serve the purpose of providing the incentives required for the operation of rental markets.

The third view may be termed the 'adjustment and residual protection' approach. This view regards the ultimate return to free market conditions as desirable, but rejects an immediate return given existing market conditions which would give rise to disruptions during the transition period. Hence, the desire for a phased adjustment. This view also accepts long-term measures against extraordinary rent increases that would jeopardize security of tenure.

The purpose of the next section is to draw out the full implications of each of these approaches to the issue of justice and fairness of the process by which rents are set. Following this, support for rent review will be examined in terms of its relation to the psychological milieu of the current inflationary environment.

[5]Urban Development Institute, "Brief to the Standing General Government Committee," (Toronto: Urban Development Institute, May 3, 1978) p.2.

The Question of Justice[6]

The question of what constitutes a just price is not a new issue. Disagreements about the fair price for a commodity undoubtedly go back as far as the process of exchange itself. The systematic treatment of the question dates back to the medieval period and the development of the concept of the 'just price'.

For the medieval Church the issue of the just price was crucial:

> "even if life in this world were only a preparation for eternal life in the next one, men had to earn their living. It was appropriate, therefore to offer them the rules that would protect them from sin while they earned their livelihoods."[7]

The danger of sin was regarded as very great indeed. For St. Thomas Aquinas, for example, the trader was considered as one "cast forth from God's temple" since he is moved by an inhuman desire for private gain (avarice) from public necessities.[8] Gratian argues that the merchant turns a means into an end and that his occupation is, therefore, "justly condemned, since regarded in itself, it serves the lust of gain."[9] Careful thought was, therefore, given to developing a concept of a just price that would enable the merchant to remain in the state of grace.

The subsequent development of economic thought moved away from the ethics of pricing and toward the development of an objective science. It is not an accident, however, that some of the leading names in economics have also been philosophers: Adam Smith, John Stuart Mill, Karl Marx, John Maynard Keynes and Friedrich Hayek. Economics is riddled with philosophy and to think otherwise is a delusion.[10]

The medieval concepts of just price are still relevant today. In all, there were five separate conceptions of what was a just price:

[6]This section was prepared with general reference to three histories of economic thought: J.A. Schumpeter, History of Economic Analysis, (Oxford: Oxford University Press, 1954); E. Roll, A History of Economic Thought (London: Faber and Faber Ltd, 1951); and M. Blaug, Economic Theory in Retrospect (London: Allen and Unwin, 1962).

[7]R. Lekachman ed. The Varieties of Economics Volume 1 (Cleveland: World Publishing Co., Meridian Editions, 1962) p.47.

[8]Saint Thomas Aquinas, Summa Theologica 2a 2ae, Q.77, Article 4.

[9]Gratian, Decretium, part 1, Q.87.

[10]For a detailed argument of this view see Joan Robinson, Economic Philosophy, (Middlesex: Pelican, 1964).

(a) the honest price

(b) the customary price

(c) the cost of production price

(d) the subjective value price

(e) the competitive price

Each of these approaches has been further developed in modern times and, indeed, form the value base that underlies contemporary economic theory. In the sub-sections that follow each of these concepts will be explained and then related to the three basic viewpoints expressed above on the desirable basis for the determination of rents.

(a) the honest price

The most basic attribute of a just price would seem to be that it be an honest one. The medieval discussion of this aspect of the just price included a number of considerations:

- that the price further the common good and be of an advantage to all parties involved;
- that there be an absence of undue force exerted on the parties to the transaction, so that it be a free act;
- that an unconscionable advantage is not exercised over a party in a difficult situation;
- that there be an absence of fraudulent representation as to the goods exchanged and
- that undue advantage not be taken of ignorance of market prices.

The cost only approach referred to earlier would argue that low vacancy rates create a situation where tenants are forced to rent at whatever price is specified by the landlord. It would further argue that rent review becomes necessary because of the disturbing incidence of cases where elderly or infirm people were faced with huge rent increases which this view regarded as unconscionable.

The free market approach regards rent review itself as an element of force which legally restricts parties from making a free transaction. Almost all free exchanges in this view are to the mutual advantage of the participants — otherwise they would not occur. Unconscionable rents are by far the exception, rather than the rule in this view, with many more cases existing of low rents being charged to the elderly or

infirm because of their position. Rent review in this view also leads to a deterioration in the service provided to tenants which may be regarded as a violation of the initial understanding of what was being exchanged. Finally, this view would not regard evasion of rent review as unjust, for it argues that rent review itself is the injustice.

The adjustment and residual protection approach accepts the basic tenet of the free market approach that controls are an exercise of force restricting freedom. It believes, however, that current low vacancy rates do put many tenants in a disadvantageous position and argues for a phased adjustment to market rents because of this problem. Problems associated with unconscionable rent increases can, in this view, be covered by the residual protection mechanism.

(b) the customary price

The customary price refers to a price that people have come to regard as normal. Whenever sharp departures from the expected normal price occur, people may question the new price as being unfair or unjust.

To the medieval mind, the concept of customary price was not a fixed one, but allowed for variation as conditions warranted. Nevertheless, there was a range of acceptable prices. The existence of such prices must be viewed in the context of the medieval period in which social relations were seen in the context of a comprehensive world order, including an ordering of social and economic relationships. Thus, the setting of wages and prices were part of the status determined by society. In addition, the regulation of prices of foodstuffs in towns was related to the hazardous nature of transportation which limited trade to local markets. In such a situation, the fixing of prices helped limit local monopolies. Similarly, for other goods, fixed prices limited the power of guilds.

Modern economic conditions in the developed world differ greatly from those of earlier times. Nonetheless, there is considerable attachment to the concept of a stable, customary price. Several factors may be at work in determining such an attitude towards prices. Long standing relationships between certain prices may become measures of intrinsic value. Unexpected shifts in prices may leave some better or worse off and give rise to adjustments in purchasing patterns and even lifestyles. Unexpected changes also produce windfall profits or losses which may be interpreted as unfair. Changes may increase uncertainty and feelings that there are forces beyond one's control.

The cost only approach to rent review does not guarantee stable prices. Substantial cost increases may occur, for example, due to changes in interest rates. Nevertheless, prices under this approach may be more stable than under a free market approach. It is also true that this view draws support from people who are primarily concerned with the problems raised above — adjustments to purchasing patterns and lifestyles, windfall gains and losses and the general feeling of there being forces at work beyond one's control.

The free market approach basically rejects the concept of customary prices. In a society like the medieval one, where social and economic changes proceed slowly, normal prices of many goods may remain relatively constant over time without causing great difficulty. In a period of fundamental change, however, considerable difficulties may arise. If the forces acting on prices have shifted, maintenance of existing prices can be expected to produce distortions involving either a serious mis-match between supply and demand or sizable government subsidies to bridge the gap. This view argues, therefore, that it is better that people adapt to the new economic realities.

The adjustment and residual protection view accepts the point that people must adapt to fundamental change. It also realizes, however, that while rigid expectations regarding prices have the difficulties outlined, it is probable that people, in fact, have expectations that are adaptive. Initially, price increases are met with anxiety and some bitterness, but the passage of time allows people to become adjusted to new price levels. Indeed, in some cases, people's expectations may become extrapolative so that they expect worse in the future. The pattern of adaptation may become either socially stabilizing or pathological in any given case. The point we are interested in at this juncture, however, is that conceptions of justice need not be static and may evolve over time. Policy may then aim at matching the rate of adjustment of prices to the rate of change in expectations.

(c) the cost of production price

Consideration of the cost of production price involves an exploration of the most fundamental differences between the alternative philosophical views regarding rent review. All views accept that prices should cover costs, but major differences exist regarding what costs are acceptable. There are four roles in the production process that are distingushed: labour, which is rewarded by payment of wages; capital, which is rewarded by profits; finance, which is rewarded by interest and land and resources which are rewarded by the payment of 'economic rent'.[11] An individual may also have costs involving things purchased from others (intermediate goods) but these costs ultimately can be traced back to the four other basic factors.

In the extreme cost only approach, only labour should be rewarded for its contribution, while the free market approach recognizes all four contributions. Accordingly, the arguments in favour of each type of financial reward will be considered. Then further comment will be made on the various views.

[11]As will be seen later on, 'economic rent' is a concept that is very different from 'rent' in the commonly understood sense. A landlord's rate of return is actually best identified with profits, although some element of 'economic rent' is also part of his return.

The concept that an individual should be entitled to the fruits of his or her own labour has a certain appeal to all those not believing in slavery. As just indicated, some take this belief to the extreme of claiming that workers should be paid the full amount of the value of the product. Accordingly, some explanation is in order as to the reason for the return to other factors.

At one time the payment of any interest on money was termed "usury" and regarded as sinful. St. Thomas Aquinas argues:

> A man commits injustice who lends wine or wheat, expecting to receive two compensations, one as the restitution of an equivalent thing, the other as a price for the use, which is called usury ....
>
> Now money, according to Aristotle was devised primarily for the purpose of effecting exchanges; and so the proper and principal use of money is the consumption or alienation of it, whereby it is expended in making purchases. Therefore, in itself, it is unlawful to receive a price for the use of money lent, which is called usury ....[12]

Subsequent consideration of the issue by churchmen yielded a number of exceptions to the rule. Four major justifications for the charging of interest have been developed. First, because there is some risk that loans will not be repaid, lenders are entitled to some compensation. Second, people in general may value current consumption more highly than delayed consumption and a reward for saving may have to be offered to those willing to postpone consumption. Third, lenders lose the opportunity of using their money in their own investments and forego the returns on such investments; interest compensates them for this lost opportunity. Fourth, interest may compensate the lender for the decrease in the value of money through inflation.

The justification of profits as a cost to be borne by the consumer is of substantial importance in the context of rent review. Six aspects of profits may be reviewed. First, some part of what may be seen as profits is actually a return to labour. This aspect may be of especially great importance in the case of small landlords. Such labour would seem to have the same entitlement to compensation as other labour. Second, part of profits will be return on capital invested. Consideration of this question will be deferred briefly. Third, as in lending, some risk is associated with one's investment, and part of profits represents compensation for that risk. Fourth, windfall gains or losses may affect profits. Such windfalls are an aspect of risk. It would seem symmetrical that anyone who would deny an investor windfall profits, would also be willing to cover his windfall losses. Fifth, some profits accrue to

[12]Aquinas, Q.78, Article 1. Reference is to Aristole's Ethics 5 and Politics 1, 5 + 6.

investors as a result of innovations — the finding of a better idea. The proper reward for innovation is a complex issue, in that it is a minor concern in rental housing, it need not be discussed here. Sixth, some profits result from the exercise of monopoly power. This issue will be discussed under the competitive price below.

The arguments for a return on capital invested constitutes, in essence, a justification for the economic system as we know it.

Marxian socialists believe that no return on capital is warranted and that the entire value of production should accrue to labour.[13] The starting point for analysis is the fact that capital is productive. People with shovels can dig dirt faster than those using their bare hands, and those using power shovels dig faster still. This point seems beyond dispute. The question at dispute, however, is whether the gains in productivity should accrue to the capitalist or to the workers who built the capital. Marxists argue that the capitalist adds nothing to value, but merely buys the product from labour with wages and sells the product at a higher price. The difference between the value of the product and that which is paid to workers is referred to as 'surplus value' which has been taken from workers in the process of 'exploitation'.[14]

The counter-argument involves three elements. First, investment requires saving. If the whole of the output of society were consumed, no capital output would exist. By not consuming all their income, capitalists make a contribution to greater output in making capital accumulation possible. Second, investment requires a decision as to the particular use. Hence, capital serves the socially productive role of transferring capital to its most productive use and in this process raises returns to other factors of production. Third, capitalism may be defended as necessary for freedom. Freedom includes economic freedom, and economic freedom would imply:

- the freedom to sell one's labour, individually or collectively, or to buy labour, at a mutually agreed on price;

- the freedom to buy or sell products at mutually agreed on prices.

Given these two freedoms, the price of products is free to be different than the price paid to labour for production.

Finally, one should keep in mind that the self-interest of the businessman may be to the public good. As Adam Smith noted:

[13]Note that this would not produce lower rents, but merely direct rental payments to the workers who initially built the building.

[14]Karl Marx, Capital: A Critique of Political Economy (London: Sonnenschein, 1886).

> But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them ... It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.[15]

Thus, trade involves a mutuality of interest, and each pursuing his own interest contributes to the good of others.

As indicated above, 'economic rent' is a very different concept from rent in the commonly understood sense of a payment to a landlord. 'Economic rent' is that part of a payment to a factor of production that is over and above that which is necessary to keep that factor in its current use. While this concept does differ from rent in its usual definition, some part of the rent paid by tenants may be 'economic rent' — that part over and above what is necessary to keep a landlord in the residential rental business.

At the current time, under rent review, one would expect that 'economic rents' ranged from large returns to negative ones. Landlords who purchased buildings long ago or who have low interest financing may be earning a considerable cash flow that is well above that required to keep them in the business. On the other hand there are landlords who are earning low returns or who have attractive investment alternatives and are experiencing negative 'economic rents' in the sense that their buildings or land would be worth more in other uses.

Another aspect of urban land that gives rise to changes in 'economic rent' relates to the changes in the location value of the building. The location value may change for any number of reasons: subway extensions; planning and zoning changes; urban growth or restrictions; creation of environmental nuisance; etc. Such changes will typically change the 'economic rent' associated with the land parcel. These gains and losses are made by landlords and by other owners of urban land, including homeowners.

However 'economic rents' arise, there will be a question of whether:

(1) the owners of the land should receive the benefits and suffer the losses;

(2) society in general should capture the benefits through taxation or pay compensation for losses;

[15]Adam Smith, The Wealth of Nations Andrew Skinner, ed. (Middlesex: Penguin Books, 1979) Volume 1, Book 1, Chapter 2, p.119.

(3) tenants should gain the benefits or losses by means of restrictions on rents in the face of changes in 'economic rents'.

The argument for allowing landlords to earn the 'economic rent' arising from their property is three-fold. First, it is, for practical purposes, impossible to separate out 'economic rents' from profits in that they are defined in terms of the subjective value of the landlord on the return necessary to keep the building in residential rental use. Second, even were it possible to separate out this value, it might be unfair to allow different rents to be charged by landlords in equivalent buildings and with similiar costs based on their subjective value. Third, in so far as the location value of rental buildings is concerned, it would seem only fair to treat landlords on the same basis as other landowners, including homeowners.

Returning now to the consideration of the three viewpoints on which the fairness of policy is being evaluated, the extreme version of the cost only approach would only accept labour or operating costs as legitimate. The incremental version of the cost only approach, accepts both labour (operating) costs and financing expenses along with the current level of profits and 'economic rent'. The free market approach accepts all four types of return without restriction; while the adjustments and residual protection approach seeks a return to market level payments to all four factors, but with limits imposed during the adjustment period to limit excess profits and excess 'economic rents' being earned.

(d) the subjective value price

This variant of a just price holds that prices should reflect the value of goods in relation to human wants. That is, prices are established by demand conditions. As such, the values of goods are not inherent in themselves, and this stands in contrast to the cost of production price.

In the late medieval period the concept of the public good was extended to a subjective theory of exchange in which a price was just if it was equal to the public's evaluation of the goods. In more modern times this approach has been associated with the philosophy of Utilitarianism. A Utilitarian ethic establishes the goal of human action as one of obtaining pleasure or avoiding pain. Prices then could reflect the pleasure derived from purchase and consumption.

In the context of rent review, it should be pointed out that the limits on rent imply that rent levels are not allowed to reflect demand conditions, that is, the full influence of the subjective value placed on rental units by prospective tenants. Under rent review there are people who are willing to pay more for a unit than the maximum allowable, but are not able to obtain that unit. In essence, rent review protects those who are willing to pay less for a unit from those who would pay more.

The cost only approach rejects the notion of demand as a factor in determining rent levels. For example, the 1965 Rent Act in Britain sought to establish fair rent which was a 'non-scarcity market rent', one that would exist in a situation of balanced demand and supply.[16] The rejection of the influence of demand is consistent with an approach that rejects the notion of increased landlord profits (see cost of production price above). The rejection also involves a rejection of the Utilitarian ethic — and this rejection may be quite explicit, with negative comment as to the self-centred hedonistic nature ascribed to this ethic.

The free market approach accepts individual consumer demand as a valid component of price determination along with costs of production. It accepts the Utilitarian concept that individuals should be free to maximize their own welfare or utility and that they should not be prevented from doing so by the existence of controls on price or quantity. It also regards increases in prices as essential as a market signal that serves to attract new supply to meet consumer needs. Finally, as regards the claim that Utilitarianism is a self-centred hedonism, the classic refutation by John Stuart Mill restates the theory so as to include a consideration of the interest of others, and the pursuit of refined human objectives.[17] Thus in this fuller statement, there exists no conflict between a Utilitarian ethic and the pursuit of public goods, redistribution of income, or consideration of the impact on others of private decisions.

The adjustment and residual protection approach acknowledges the contribution of demand, but would mute the full impact of demand on prices during the period required to adjust to market balance. It also involves a longer term limitation on rent increases related to the maintenance of security of tenure — but this limit is to be structured so as to allow market levels of rent to be charged and, hence, would reflect demand conditions.

(e) the competitive price

The competitive price results from the interplay of supply and demand in free markets. The supply of the product takes into account the costs of production, while demand is based on the subjective value of consumers. Thus, this approach combines elements of the last two approaches. In addition, the competitive requirement prevents the imposition of terms by buyer or seller.

This view of prices was also considered as a just price in medieval times. Today it forms the basis of the support for free markets.

It is rejected, however, by the cost only approach both because of the inclusion of demand considerations and of payments to all factors of production.

[16] J. B. Cullingworth, "Rent Control and Redistribution," p.11.

[17] John Stuart Mill, Utilitarianism, (Indianapolis: Bobbs Merril, 1971).

The adjustment and residual protection approach accepts the restoration of competitive prices as a long-term objective that will be reached over time.

It is useful to consider the arguments for and against the use of the competitive price. There are a number of arguments that would seem to support the competitive price as being a just price.

First, competition implies economic freedom for both buyer and seller. The choices of consumers are not restricted to a limited range of alternatives and potential producers are free to enter the market. In the housing market, the existence of thousands of landlords would seem to give rise to such competition.

Second, in the absence of distorting influences, the competitive price is consistent with economic efficiency. As such, the economic output of the economy is maximized under conditions of competition. While the maximization of output cannot be taken as the sole goal of society, the availability of goods and services can assist in meeting utilitarian objectives.

Third, with competitive prices, all those purchasing will obtain the product for an amount less than or equal to the subjective value of the product to them. All sellers will receive an amount as great as, or greater than, the minimum price at which they would be willing to supply the commodity. And the price level arrived at is the one that will balance supply and demand.

The competitive price approach has been subjected to a number of challenges as to the justice of results produced.

One group of people dispute the justice of return to capital that is inherent in this approach. Discussion of this issue has already been presented in the section on the cost of production price.

A second group hold that while competition is desirable, it is not realistic. They believe that there is a tendency toward monopoly power in the economy produced by market forces. However, the rental housing sector has many thousands of landlords, therefore, monopoly power is unlikely to be serious.

A third group of people acknowledge the advantages of competition, but believe that the distribution of income is unfair with the result being an injustice in the distribution of resources in general and housing in particular. These problems would not necessarily call for intervention into the setting of housing prices in that housing and income transfer policies may solve this problem.

The Current Inflationary Environment

The neat philosophical arguments of the last section can be obscured by the confusion arising in these turbulent times. High inflation, uncertain conditions and slow growth can easily give rise to support or opposition of various rent review measures. This section will explore several psychological impacts of current conditions on attitudes to rent review.

Here we will explore:

(a) problems of perception;

(b) problems of uncertainty;

(c) over-ride of market solutions;

(d) relation to the causes of inflation.

(a) problems of perception

With wages and prices increasing at a rate of 12 per cent, a 6 per cent rent increase can in one sense be thought of as a price decrease. That is, the price of a rental unit is going down relative to other prices and incomes.

Those who support rent review would tend to regard the 6 per cent increases as an increase. Those who do not support rent review, would tend to focus on the relative decrease.

A second perceptual problem may occur in a case where, for example, a tenant receives a 10 per cent income increase in May and a 6 per cent rent increase in September. If the tenant compares the current situation in September with that of last April the tenant is better off. If, however the comparison is with August, the tenant is worse off.

(b) problems of uncertainty

One of the attractions of rent review may be that it adds to the certainty as to what rent increases will be. Thus, for some tenants the main attraction is the lessened probability of having a very high increase. Indeed, an absolute maximum rent increase of 12 per cent might be preferred to a rent review system if the latter carries a risk of a 20 per cent or higher rent increase in cases of refinancing on building sale.

It should be pointed out that any abatement of risk to tenants produces an equal and opposite intensification of risk for landlords. That is, controls increase the burden of inflation on landlords in that higher inflation reduces the real value of their profits.

(c) over-ride of market solutions

High inflation, low economic growth and slow promotions for those in the baby boom generation may produce a high degree of frustration with the gap between the economic results produced by the functioning of the marketplace vs. their expectation of better results. Several authors have noted the increasing tendency for people to opt for a government over-ride of market results.[18] Again, the gains of the group receiving advantages, in this case tenants, is balanced by equal losses of others, namely landlords. The amount of this transfer was detailed in Chapter 7, Redistribution.

(d) relation to the causes of inflation

Support or opposition to rent review is also dependent on the view one has as to the principal cause of inflation. Support for rent review can be expected to increase as one perceives that the rent increases by landlords are a principal contributing cause to inflation. In 1975, it is likely that many believed this, although others would have believed that rent increases were the result of inflation (high cost and financing increases) rather than its cause. At the present time, it is likely that few believe that 6 per cent rent increases are a principal cause of 12 per cent inflation. Indeed, there is a view that low rent increases simply mean that demand is channeled into other goods and services which in turn drives up their prices, so that holding down rents does not make an appreciable contribution to holding down the general rate of inflation.[19] While there is some truth to this, this view is probably overstated in that part of the rent saving is saved rather than spent elsewhere.

[18]For example T.J. Courchene, "Towards a Protected Society: The Politicization of Economic Life" Canadian Journal of Economics XIII,4 (November 1980): pp. 556-557; L.C. Thurow, The Zero-Sum Society (New York: Basic, 1980).

[19]R.W. Ault, "The Presumed Advantages and Real Disadvantages of Rent Control" in Rent Control: Myths and Realities, pp.59-60.